NOTES

PART I

Chapter 1

1. If corporate income were not subject to tax until distributed to shareholders, retained earnings would be taxed under the individual income tax system only when shareholders realize capital gains on the sale of stock. Shareholders could defer or avoid individual income tax simply by retaining earnings in corporations. See Pechman (1987) and Warren (1981). While this argument counsels against repeal of the corporate income tax, it does not apply to the integration proposals discussed in this Report, none of which permit such indefinite deferral of tax on corporate income.

Some have suggested that a mark-to-market regime for corporate stock would remove the potential deferral associated with investment in corporations and, thus, the need for the corporate tax. Under a mark-to-market regime, shareholders would recognize each year the change in the value of the corporation, including corporate income. See Shakow (1986) and Thuronyi (1983). While marking to market corporate stock could be considered a method of integrating the corporate and shareholder tax systems, it also would tax shareholders on income that is unrealized at the corporate level. We do not explore that approach in this Report, because abandoning the realization requirement goes well beyond the changes necessary to achieve integration.

2. Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085, Oct. 22, 1986.

3. *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

4. This increase in welfare compares favorably to that estimated for the 1986 Tax Reform Act at the time of its adoption. See Fullerton, Henderson, and Mackie (1987).

5. Appendix A contains a more detailed discussion of the taxation of corporations under current law.

6. Characterizing the corporate income tax as a double tax rests on the assumption that the corporate level tax reduces corporate income available to shareholders. If the corporate tax does not reduce profits but instead increases prices charged to consumers or lowers wages paid to workers, little or no additional tax may be paid on dividends. Section 13.G discusses the incidence of the corporate tax. In addition, not all income earned by corporations is taxed when earned, and not all shareholders are subject to taxation. Chapter 5 discusses tax preferences and Chapters 6 and 7 examine the issues of tax-exempt and foreign investors.

7. The Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, 104 Stat. 1388 (the 1990 Act) made three changes in the individual income tax rate structure. First, the 1990 Act increased the top marginal tax rate for individuals to 31 percent from 28 percent. A number of other statutory provisions may affect statutory marginal rates. For example, the 1990 Act created an explicit phaseout of personal exemptions for taxpayers with adjusted gross income (AGI) above certain thresholds. For a married couple filing jointly, for example, the deduction for personal exemptions phases out at a rate of 2 percent for each $2,500 of AGI above $150,000. The 1990 Act also enacted a rule disallowing a portion of itemized deductions otherwise allowable to high-income taxpayers. Itemized deductions (other than medical, casualty and theft, and investment interest deductions) are generally reduced by 3 percent of AGI in excess of $100,000, except that the disallowance cannot exceed 80 percent of the affected itemized deductions.

8. Interest received by foreign lenders that are related to the borrower or by foreign banks on loans made in the ordinary course of business, is, however, subject to withholding tax at 30 percent or a lower treaty rate.

9. In addition to the distortions created by the two-tier tax, distortions may result from the rules used to measure business income. For example, the Code generally fails to correct for distortions in the tax base attributable to inflation or to the requirement that a capital gain be realized before being subject to tax. These measurement problems affect both corporate and unincorporated business income. Because the general reform of business income measurement rules is beyond the scope of this Report, we take the existing system of income measurement rules as given.

10. See Harberger (1962 and 1966) and the subsequent studies cited in Chapter 13, note 1.

11. This simple example abstracts from other factors affecting the cost of capital, including: (i) differences between tax and economic depreciation; (ii) differences in tax rates among investors; and (iii) inflation.

12. See Gravelle (1991). These calculations assume (i) a rate of inflation of 4 percent; (ii) an average holding period of 7 years; and (iii) that two-thirds of capital gains are deferred until death.

13. Data for the past few years (some of it preliminary) shows a reduction in the size of the corporate sector relative to the noncorporate sector and the overall economy. Particularly since 1986, S corporations have accounted for an increased share of corporate profits. Long-term comparisons of corporate activity with general economic activity, however, present no clear trend toward disincorporation. See Chapter 13.

14. See Gravelle (1991).

15. Inflation adds a complication here. Because the tax system taxes nominal rather than real returns, the deductibility of interest expense under current law offers an even greater tax advantage to corporate debt financed investments (relative to corporate equity financed or noncorporate investments) in the presence of inflation, since corporations typically deduct nominal interest payments at a higher tax rate than the rate at which lenders are taxed on these payments. See Fullerton, Gillette, and Mackie (1987) and Gertler and Hubbard (1990).

16. While both book-value and market-value measures are subject to criticism, market-value measures of debt burdens are generally superior for measuring bankruptcy risks because they reflect inflation and other factors that influence the value of alternative claims on the firm. See, e.g., Bernanke and Campbell (1988) and Warshawsky (1991).

During inflationary periods, book-value measures tend to overstate the burden of debt and to understate the value of a firm's assets. The debt burden may be overstated because with inflation part of the interest rate reflects a return of principal, not a real cost to the firm. As a result of inflation, new debt can be issued without increasing the effective debt burden of the firm; some new debt would merely represent a rollover of the portion of the real principal that must be repaid, rather than a net issuance of new debt. In addition, to the extent that inflation is higher than anticipated, the burden of a given amount of debt falls because real income is transferred from bondholders to shareholders. Book-value ratios also understate the value of the firm's assets because traditional accounting measures of asset values are based on the historical price of the asset, not on its current market (replacement) price. In addition, because book-value debt to asset ratios do not reflect changes in equity values, they may be misleading indicators of the true burden of debt, especially during periods (such as the 1980s) with large increases in stock prices.

While market-value measures of the firm's debt and equity reflect adjustments for inflation and for other changes in the market value of the firm and its securities, they also may be criticized. First, market-value measures generally are estimated rather than directly observed. One approach for estimating the market value of equity and debt, for example, is to capitalize dividend and interest payments, respectively. The Federal Reserve market value ratio shown in Figure 1.5 is a more sophisticated measure, but it also relies on estimates of equity and debt values. Second, market-value ratios are inaccurate if stock market prices do not reflect fundamental values.

17. See, e.g., Shoven (1987) and Auerbach (1989). Share repurchases are discussed further in Chapters 8 and 13.

18. See the evidence in Shoven (1987) and Auerbach (1989).

19. Estimates are based on data for dividends and buybacks from the COMPUSTAT II database, Standard and Poor's COMPUSTAT Services, Inc. Assuming the corporate AAA bond interest rate for all years, the figures represent the maximum interest properly attributable to the increase in share repurchases because they assume that (1) repurchases were financed completely by debt, and (2) the additional debt remains outstanding during the 1980s. The elimination of the capital gains exclusion by the 1986 Act reduced the attraction for investors of share repurchases, since the gain component of the distribution is no longer generally taxed at preferential rates. Share repurchases continued strong through 1989, but declined in 1990.

20. Similarly, leveraged buyouts (LBOs), which replace substantial equity with debt, also may have contributed to the increase in corporate debt during the 1980s. The dollar value of completed mergers and acquisitions in the United States rose at an annual rate of 14.3 percent between 1981 and 1989. The LBO share of this activity rose 8.6 percent in 1983 to 22.7 percent in 1986, but receded to 18.4 percent in 1989 (excluding RJR Nabisco), dropping sharply to 9.3 percent in 1990. (Source: Mergers and Acquisitions, Almanac and Index, May-June 1985-1991). By the end of 1988, outstanding LBO debt was estimated to be about 20 percent of the (book) value of outstanding corporate bonds or more than 9 percent of the (book) value of total nonfinancial corporate debt (based on data from the Federal Reserve Board's Flow of Funds Accounts,

Financial Assets and Liabilities, Year End (1967-1990), hereinafter cited as Flow of Funds Accounts). See Gertler and Hubbard (1990)).

21. See, e.g., Warshawsky (1991).

22. See Friedman (1990) and Gertler and Hubbard (1990).

23. Potential nontax benefits of debt finance are discussed in Chapter 13. See also Jensen (1986) and Gertler and Hubbard (1990).

24. See Chapter 13 and Gordon and Malkiel (1981).

25. The Congressional Research Service estimates that the shareholder level effective Federal income tax rate on dividends is 32 percent, compared to 11 percent or less on capital gains attributable to retained earnings. See Gravelle (1991).

26. This assumption is controversial, since not all economic models of the effects of taxation on dividend payments maintain that nontax benefits are associated with dividend payments. There are two leading explanations of why corporations continue to pay dividends in spite of the greater investor level tax burden on dividends than on capital gains attributable to retained earnings or share repurchases: the "traditional view" and the "new view." The "traditional view" asserts that dividends offer nontax benefits to shareholders that offset their tax advantage. Accordingly, dividend taxes distort payout decisions and raise the cost of capital. The "new view" assumes that dividend payments offer no nontax advantages to shareholders and that corporations have no alternative to dividends for distributing funds to shareholders. Under this assumption, dividend taxes reduce the value of the firm, but do not affect firms' dividend or investment decisions. This Report adopts the framework suggested by the "traditional view." The two approaches are discussed in more detail in Chapter 13.

27. These studies are discussed in Section 13.B.

28. The 1970 data in the text are from Shoven (1987). The 1989 and 1990 data are from Department of the Treasury calculations based on tabulations of the Standard and Poor's COMPUSTAT Industrial and Research files.

29. The effect of taxation on savings is uncertain because changes in the after-tax rate of return have an ambiguous effect on savings. A higher after-tax return makes future consumption cheaper than foregone present consumption. This substitution effect encourages households to reduce present consumption and increase savings. However, a higher after-tax return also allows a given level of future consumption to be reached with less savings today. This second effect, called the income effect, reduces saving. Because the substitution effect of a rise in the after-tax return increases saving, while the income effect reduces saving, the net effect of a rise in the after-tax return is an empirical question.

30. As noted in note 29, the net effect of changes in the after-tax rate of return on saving is difficult to determine because it depends on opposing income and substitution effects. There is less theoretical uncertainty about the direction of the effect of capital taxation on investment. The distinction between saving and investment is an important one in an analysis of corporate taxation. In an economy without international trade and investment flows, national saving equals national investment, and the average cost of capital summarizes tax incentives to save as well as to invest. International capital flows break the equivalence of domestic saving and investment, however. In a world with perfect international capital mobility, incentives for domestic investment would be governed by the pre-tax return needed to cover taxes and the worldwide opportunity cost of funds. At the same time, domestic saving would depend on the after-tax return earned by savers from investing at the worldwide rate of return. Hence, domestic investment depends on domestic corporate level taxes, while domestic saving depends on domestic individual level taxes.

31. U.S. Department of the Treasury, Tax Reform for Fairness, Simplicity, and Growth (1984) (hereinafter cited as Treasury I), Vol. 2, pp. 135-144 and The White House, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (1985) (hereinafter cited as The President's 1985 Proposals), pp. 120-129. See also U.S. Department of the Treasury, Blueprints for Basic Tax Reform (1977) (hereinafter cited as Blueprints).

32. See Appendix B.

33. See, e.g., McLure (1979).

34. So-called partial integration (referred to in this Report as distribution-related integration) has been viewed as a compromise between the passthrough ideal and considerations of administrability. A conventional definition of full integration

is given in McLure (1979), p.3: "...income earned at the corporate level, whether distributed or not, would be attributed to shareholders, as in a partnership, and taxed only at the rates applicable to the incomes of the various shareholders."

35. Appendix C discusses the effect of rate relationships on integration proposals.

36. For general discussion of economic benefits of neutrality in the taxation of capital income, see Institute for Fiscal Studies (1978) and Bradford (1986).

37. See Sections 2.D and 4.F.

38. This Report also does not generally address tax distortions created by inflation.

39. Under a corporate cash-flow tax, corporations would be taxed on the net cash flow from their business activities. Corporate cash-flow taxes have generally been advanced as part of an overall restructuring of the tax system that would replace the individual income tax with a consumption or cash-flow individual tax. See Institute for Fiscal Studies (1978), Aaron and Galper (1985), and Bradford (1986). Recently, however, some economists have proposed cash-flow taxes on businesses, while the current income tax rules would be maintained at the individual level. See, e.g., King (1987), Feldstein (1989), and Hubbard (1989).

Under one corporate cash-flow tax proposal, a corporation would determine its tax base by subtracting from its receipts from sales of goods or services its cost of purchasing real goods and services for production. No deductions for financing investments would be allowed; that is, neither dividends nor interest payments would be deductible. Several significant changes would be required to convert the current corporate income tax base to a cash-flow tax base, including replacing depreciation deductions with a deduction for the cost of capital assets in the year of acquisition (expensing), and eliminating corporate investment interest deductions. Other ways to define the base of a corporate cash-flow tax are discussed in Institute for Fiscal Studies (1978) and King (1987).

Proponents of a cash-flow tax emphasize that, because the initial purchase of assets would be deductible, the system would generate a zero marginal effective tax rate on investment. In effect, the tax system would not distort the cost of capital investment decisions. Income generated in the corporate sector, however, would continue to bear a tax at the individual level. In contrast, noncorporate business income would face no tax at the margin if it were taxed on a cash-flow basis. Hence, a bias against investment in the corporate sector would still exist.

Because interest payments would not be deductible, the tax advantage that debt enjoys under the current system would be eliminated, but a cash-flow tax would not achieve neutrality with respect to choice of finance. Rather, under the reasonable assumption that the marginal individual tax rate on dividends exceeds the marginal effective accrual tax rate on capital gains, retained earnings would have an advantage over either debt or new equity as a source of corporate finance.

40. See generally Treasury I.

Part II

Introduction

1. While the prototypes discussed in this Part and in Part IV contain considerable technical detail, they do not provide a comprehensive summary of technical changes that would be required. For example, the prototypes do not address the effect of an integration system on groups of corporations filing consolidated returns. We concluded, consistent with the approach to consolidated return matters under the current corporate tax system, that consolidated return issues are better addressed after a basic integration approach is selected.

2. The distribution-related integration systems of several major U.S. trading partners are described in Appendix B.

Chapter 2

1. Peel (1985) also proposes a dividend exclusion system. While Peel's proposed system resembles the dividend exclusion prototype discussed here (e.g., in allowing shareholders to exclude dividends only to the extent of income that has been taxed fully at the corporate level), there are significant differences. For example, Peel's proposed system would track taxable

income rather than taxes paid, would extend the benefits of integration to foreign shareholders by statute, and would treat foreign taxes like U.S. taxes in determining the extent to which a corporation's income has borne tax.

From 1954 to 1986, the Code provided a very small exclusion for dividends received by individuals. Immediately preceding repeal, IRC § 116 provided an exclusion of up to $100 of dividends received ($200 on a joint return).

2. Although a detailed treatment of the financial accounting consequences of adopting an integrated system is beyond the scope of this Report, and the financial accounting authorities have never addressed the integration prototypes developed in this Report, a few preliminary observations can be made. Because the dividend exclusion prototype generally retains the current rate structure and rules for calculating corporate income subject to tax, adoption of the prototype should not significantly change corporations' provision for income tax expense or the determination of taxes currently payable or payable at a future date. Of course, the economic effects of moving to an integrated tax system, e.g., changes in corporations' distribution policies and capital structures, would be reflected in financial statements.

3. This is similar to an imputation credit system that taxes corporate income at a 34 percent rate and allows shareholders imputation credits at the individual shareholder rates.

4. An imputation credit system that denies refundability of imputation credits to tax-exempt shareholders achieves the same results. See Section 11.E.

5. An imputation credit system that relies on a shareholder credit limitation rather than a compensatory tax reaches the same result. See Section 11.B.

6. An imputation credit system reaches the same result if foreign taxes are not added to the shareholder credit account. See Section 11.D.

7. In an imputation credit system, this result can be achieved by denying refundability of imputation credits to foreign shareholders and continuing to impose withholding tax. See Section 11.E.

8. For simplicity, Table 2.1 (and the corresponding tables in Chapters 3, 4, and 11) refer to the tax imposed on a foreign investor's noncorporate equity income as a withholding tax, t_{WN}, although the method and rate of taxation actually vary depending on the type of income. Very generally, a foreign investor is taxed on income from an equity investment in a noncorporate business as if the foreign investor had earned directly the income earned by the business. A foreign investor is generally subject to tax at rates applicable to U.S. persons on income that is "effectively connected" with a U.S. trade or business. A partnership generally must withhold tax from a foreign partner's distributive share of effectively connected income under IRC § 1446. A partnership also withholds tax on a foreign partner's distributive share of dividends, interest, and other income to the extent required by IRC § 1441.

9. A compensatory tax is used in some foreign imputation credit systems, e.g., the United Kingdom, France, and Germany, to ensure that corporate level preferences are not extended to shareholders. See Appendix B.

10. Because the prototype treats AMT as corporate taxes paid, it does not treat as taxes paid the portion of a later year's regular taxes that are offset by the AMT credit allowed by IRC § 53.

> Example. A corporation earns $100 of preference income. The corporation's regular tax is $0, and its AMT is $20. The addition to the EDA is $38.82 (($20/.34)−$20). This is the amount of hypothetical income that would be left for distribution if the corporation had earned taxable income of $58.82 and paid $20 of regular tax at the 34 percent rate ($58.82 \times .34 = 20$).

11. In mathematical terms, for each dollar of taxes paid, the corporation can add $(1/t)-1$ to its EDA, where t is the corporate tax rate. This formula also can be expressed as $(1-t)/t$.

The graduated rates set forth in IRC § 11(b) for corporations with incomes of less than $75,000 would continue to be available. Converting the entire amount of taxes paid at a 34 percent rate provides a simple rule and should not harm most corporations, because the benefit of graduated rates begin to phase out for corporations with taxable incomes greater than $100,000. It would, however, be possible to modify the EDA conversion formula to reflect graduated rates. One possibility is to build the graduated rate structure into the EDA formula for corporations with taxable incomes of less than $100,000 by permitting conversion of the first $7,500 of taxes paid at the 15 percent rate (into $42,500 of EDA) and conversion of

the second $6,250 of taxes paid at the 25 percent rate (into $18,750 of EDA). These amounts would be reduced for corporations in the phaseout range.

12. Example. In year one, a corporation reports $100 of income and pays $34 of tax. The corporation's EDA balance is $66, and it pays an excludable dividend of $66. In year two, the corporation incurs a net operating loss of $50 and files a claim for refund of $17. Making that adjustment retroactive to year one would require adjusting shareholders' incomes to reflect a taxable dividend of $33. Because this is impractical, the prototype requires that the refund in the year of the adjustment be carried forward to be applied against future corporate taxes.

13. Payment of a refund when the EDA balance is exhausted would, in effect, refund corporate taxes that have already been used to qualify distributions as excludable by shareholders; only by requiring a negative balance in the EDA could this be compensated for in later years.

14. We rejected the alternative of permitting refunds and NOL carrybacks to create a negative EDA. If such an approach were adopted, a negative EDA would be increased by subsequent payments of corporate tax. In addition, a corporation with a negative EDA would be required to pay additional tax to increase its EDA to zero upon certain events, e.g., upon liquidation.

15. While a 100 percent dividends received deduction could be extended to all corporate shareholders to defer completely taxation of corporate preference income until it is distributed out of corporate solution, it would add approximately $400 million to the revenue cost of the dividend exclusion prototype. Because of the additional complexity that would arise from a partial dividends received deduction under an imputation credit system, we make a different recommendation under that system. See Section 11.B.

16. As under current law, hybrid instruments and derivative products (e.g., convertible debt and options may allow a tax-exempt or foreign investor to capture the portfolio benefits of holding stock while avoiding corporate level tax.

17. One anti-streaming mechanism is inherent in the prototype. Because all dividends paid reduce any positive balance in the EDA, a corporation cannot simultaneously pay excludable dividends on one class of stock and taxable dividends on another. The imputation credit system, described in Chapter 11, allows greater flexibility in attaching shareholder level tax credits to dividends and, as a result, demands additional anti-streaming restrictions.

Requiring dividends to reduce the EDA does not prevent all streaming, however. For example, excludable dividends can be paid to taxable shareholders to the extent of the EDA and thereafter all taxable dividends can be paid to tax-exempt shareholders. Further, complex corporate structures and corporate reorganization (either acquisitive or divisive) also might be used to stream excludable dividends by isolating or shifting shareholders' interest in a corporation's EDA. If necessary, anti-abuse rules can be formulated to prevent such arrangements.

18. IRC § 246 (which governs corporations' eligibility for the dividends received deduction) may provide a model for developing related rules.

19. IRC § 1059 limits the ability of corporate shareholders to strip dividends by claiming the dividends received deduction with respect to distributions more properly treated as a return of capital. It does so by requiring stock basis to be reduced to the extent of the dividends received deduction with respect to extraordinary dividends paid within 2 years of an acquisition of stock. The appropriate scope of an IRC § 1059-type basis adjustment will depend on the treatment of capital gains under integration. See Chapter 8.

As discussed in the text under "Corporate Shareholders," an excludable dividend received by a corporate shareholder increases the recipient's EDA. Consideration should be given to whether additional anti-streaming rules are necessary to prevent streaming through the shifting of EDA balances among corporations.

20. Under IRC § 305(b)(2), a distribution (including a deemed distribution) by a corporation of its stock is treated as a dividend if the distribution (or a series of distributions of which distribution is a part) has the result of (1) the receipt of money or other property by some shareholders, and (2) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. For example, assume a corporation issues two classes of common stock in an attempt to stream excludable dividends to certain shareholders. The first class pays excludable dividends and is intended to be held by taxable persons. The second class pays stock dividends (or receives an increased interest in the corporation's assets) and is intended to be held by tax-exempt persons. In such a case, IRC § 305 would impute dividends on the second class of stock and the corporation's EDA would be reduced accordingly.

Similarly, IRC § 305(c) authorizes the Department of the Treasury to issue regulations treating a wide variety of transactions as constructive distributions to any shareholder whose proportionate interest in the corporation's assets or earnings and profits is increased thereby. For example, IRC § 305(c) would prevent a corporation from issuing preferred stock on which a redemption premium substitutes for dividends.

21. Example. Corporation X is owned by a tax-exempt shareholder, and its only asset is a $100 EDA balance, e.g., because it previously distributed preference income and retained only enough cash to pay the tax liability when the preference subsequently turned around. Corporation Y is owned by taxable shareholders and has substantial preference income and cash but a $0 EDA balance. Corporation Y acquires corporation X in a tax-free merger described in IRC § 368(a)(a)(A), and subsequently uses X's EDA balance to distribute $100 of Y's cash as excludable dividends. If Y's $0 EDA balance is attributable to deferral preferences, it will ultimately owe tax when the preferences turn around. However, the acquisition of X's EDA enables Y to defer tax on the preference income that otherwise would have resulted from Y's current distribution of dividends.

22. The American Law Institute, Reporter's Memorandum No. 3, (1991), pp. 7-8, makes a similar recommendation in discussing an integration proposal involving maintenance of a "taxes paid account" at the corporate level.

23. In the interim, the rules of IRC § 269 could be applied to prevent the most obvious tax-motivated acquisitions.

24. Similar issues arise under the shareholder allocation and imputation credit prototypes, but we do not discuss them separately in Chapters 3 and 11. The dividend exclusion prototype taxes corporate equity income once at a 34 percent rate, regardless of the tax rate of the shareholder. Thus, if an interest disallowance rule applied, it should apply regardless of whether the dividends paid on the stock are excludable or taxable. While excludable dividends bear a superficial similarity to tax-exempt interest under IRC § 103, one level of tax on the earnings used to pay the dividend has been collected. Similarly, taxable dividends paid, for example out of preference income, to a taxable shareholder also bear one level of tax, although at the shareholder's rate. Thus, if an interest disallowance rule were adopted, it would be inappropriate to apply it only to the extent of excludable dividends. On balance, this Report does not recommend developing rules to deal with the potential rate arbitrage of equity holders borrowing from low rate or tax-exempt lenders for either excludable or taxable dividends. See note 25.

25. As under current law, the general deductibility of interest permits significant rate arbitrage through the issuance of debt by taxable issuers to tax-exempt and foreign lenders. the relative importance of the rate arbitrage potential of borrowing to purchase corporate stock may be less in an integrated system that does not change the treatment of interest generally. In contrast, CBIT generally eliminates businesses' ability to pay interest to tax-exempt and foreign lenders without the payment of one level of tax. Thus, in CBIT, we found it appropriate to eliminate investor level rate arbitrage through borrowing as well. Compare IRC § 246A.

26. No other country with an integrated system has adopted this approach, however.

27. If such treatment of foreign taxes were permitted, special rules would be required to ensure that appropriate amounts are added to the EDA when foreign tax rates exceed the U.S. rate. If the foreign tax rate is less than the U.S. rate, foreign taxes paid could be converted into the appropriate EDA balance by applying the formula set forth in Section 2.B.

Example 1. A corporation has $100 of foreign source income and pays $20 in foreign taxes. After applying the IRC § 904 limitation, the corporation would be entitled to credit all $20 of foreign taxes against its U.S. tax liability of $34. The U.S. residual liability would be $14, which would convert into a $27 ($14/.34−$14) addition to the EDA. The $20 of foreign taxes paid would convert into a $39 ($20/.34−$20) addition to the EDA. The total EDA would be $66, which would enable the corporation to distribute its after-tax earnings of $66 as excludable dividends.

However, if foreign tax rates exceed U.S. tax rates, the foreign taxes cannot be converted into an EDA balance using the formula set forth in Section 2.B. In that case, the foreign taxes must be converted using the higher foreign tax rate.

Example 2. A corporation has $100 of foreign source income and pays $40 in foreign taxes. After applying the IRC § 904 limitation, the corporation would be entitled to credit $34 against its U.S. tax liability of $34. The U.S. residual liability would be $0. It would be inappropriate, however, to add $66 to the EDA, because the corporation has only $60 ($100 income−$40 foreign taxes) of after-tax earnings to distribute. Adding $66 rather than $60 would permit the distribution of $6 of U.S. source preference income without shareholder level tax. Thus, the amount to be added to the

EDA should be limited to $60, which can be accomplished by applying the EDA formula to actual foreign taxes paid using the higher foreign rate ($40/.4 − $40).

This approach would create some complexity at the corporate level, because it would require separate tracking of foreign taxes paid and foreign tax rates. The alternative of tracing foreign income and adding to the EDA foreign income less foreign taxes is likely to be at least as complex.

28. A low taxable income is not necessarily inconsistent with wealth. For example, a low-bracket individual may have large amounts of income from tax-exempt sources, e.g., tax-exempt bond interest. Alternatively, a low-bracket individual who is retired may have a small income but a large accumulation of wealth. That is, individuals may prefer to maintain a level of consumption over their lifetime, and thus reduce consumption during high-income working years in order to be able to maintain consumption during low-income retirement years. See, e.g., Ando and Modigliani (1963).

29. The credit formula is: Credit = (DIV/.66)×(.34 − t), where DIV is the dividend and t is the shareholder's marginal rate. This credit formula is designed to replicate the excess credit under an imputation credit system, i.e., the difference between the imputation credit (.34×(DIV/.66)) and the amount of shareholder tax due on the grossed up dividend at the shareholder rate (t×(DIV/.66)).

30. Alternatively, relief for low-bracket shareholders also might take the form of a deduction. The credit formula could be converted into a deduction formula by dividing the credit by the shareholder tax rate: [(DIV/.66)×(.34 − t)]/t, where DIV is the net dividend and t is the shareholder's marginal rate. Thus, a shareholder in the 15 percent bracket would be entitled to a deduction of $127 (($66/.66)×.19/.15).

31. A corporation's EDA would be allocated among shareholders in proportion to the amount of other assets distributed to them.

32. The policy underlying the reorganization provisions is that imposition of tax is inappropriate if a corporate reorganization merely effects a readjustment of shareholders' continuing interests in corporate property under modified corporate forms. This policy applies equally under the prototype, because it reflects a judgment about when income should be recognized under a realization-based tax system that does not require corporate assets or stock to be marked to market, not a judgment about whether two levels of tax should be imposed on recognized corporate income.

33. Under current law, earnings and profits of the distributing corporation in a divisive reorganization that qualifies as a reorganization under IRC § 368(a)(1)(D) are divided between the distributing corporation and the controlled corporation based on the relative fair market value of their assets.

34. Under current law, nonliquidating distributions to shareholders are treated as dividends to the extent paid out of the corporation's post-February 28, 1913, accumulated earnings and profits or its earnings and profits for the current taxable year. The earnings and profits rules may be viewed as serving two principal functions with respect to dividend taxation. First, the earnings and profits rules may be seen as a mechanism to assure that corporate preferences are not extended when preference income is distributed to shareholders. Second, the rules may be seen as a mechanism to distinguish whether a distribution represents a distribution of income earned on the shareholder's investment or a return of that investment.

35. IRC § 301(c).

36. See, e.g., Andrews (1956), Blum (1975), and American Bar Association (1986).

37. Earnings and profits also are relevant in contexts other than determining dividend taxation. Earnings and profits are relevant, for example, in determining the extent to which gain on a disposition of IRC § 306 stock is recaptured as ordinary income, whether certain corporate divisions qualify for tax-free treatment under IRC § 355, the amount of taxes paid by a foreign corporation that under IRC § 902 are credited to its 10 percent corporate shareholder upon receipt of a dividend, the amount of Subpart F income that must be currently included in income by a United States shareholder of a controlled foreign corporation, whether an S corporation with substantial passive income is subject to entity level tax on such income under IRC § 1375 or whether such income causes the termination of S corporation status under IRC § 1362(d)(3); the amount of any basis adjustments in the stock of consolidated subsidiaries pursuant to the consolidated return regulations, and the amount of the adjusted current earnings adjustment for AMT purposes. In some contexts, it is possible to eliminate references to earnings and profits or to devise alternatives that are simpler. Nevertheless, in other contexts—especially in the rules governing the taxation of foreign income—developing simple alternatives may prove more difficult. The benefit of

eliminating the earnings and profits rules for purposes of dividend taxation is considerably reduced if alternatives are not found for the rules in other contexts.

38. Recently, the American Law Institute Reporter circulated a draft memorandum that would eliminate earnings and profits as part of its distribution-related integration proposal. American Law Institute, Reporter's Memorandum No. 3 (1991), p. 5.

39. Just as under current law, however, the connection between earnings and profits and the economics of shareholder investment is severed, however, by sales of stock and other transactions or events increasing or decreasing shareholder basis without adjusting earnings and profits. Preserving the connection would require earnings and profits accounts to be maintained and adjusted on a per share basis. Thus, for example, a seller of stock in a corporation with retained earnings would recognize dividend income to the extent of the earnings and profits attributable to such stock and the earnings and profits account for the stock would be reduced to zero. This system would not be feasible for actively traded stock. Accordingly, the earnings and profits rules may yield arbitrary and incorrect results from the shareholder's perspective. The alternative rules are likely to be no more accurate in distinguishing between income distributions and returns of capital because they also do not take into account changes at the shareholder level. Indeed, by eliminating earnings and profits as a limitation on dividend taxation, the alternative rules would tend to increase the likelihood of imposing dividend taxation on a distribution that economically is a return of shareholder investment.

40. For a discussion of the equivalence of deducting the cost of an investment and exempting investment income from tax, see Graetz (1979), Warren (1975), Andrews (1974), and Brown (1948).

Chapter 3

1. If income is not taxed at the corporate level (because of tax preferences or foreign tax credits), there is no additional tax burden on retained earnings, and therefore corporations will tend to retain preference income. Under the dividend exclusion prototype, as well as under the current system, retained preference income is taxed at the shareholder level only when the stock is sold. To the extent that retaining preference income increases the value of stock, it also increases the capital gain realized on the sale. Thus, distribution-related integration treats retained corporate preference income more favorably than distributed preference income.

2. Because the shareholder allocation prototype would generally continue to tax the corporation in the same manner as under current law, it should not significantly change a corporation's financial statement provision for income tax expense, taxes currently payable, and taxes payable at a future date. The prototype's denial of carrybacks for net operating losses and removal of the corporate AMT will, however, be reflected in the reporting of corporate tax liability for financial accounting purposes.

The denial of carryback treatment for net operating losses may increase the provision for income tax expense in certain circumstances. For financial accounting purposes, when a operating loss can and will be carried back, the tax effects of such carryback generally increase net income, or reduce the net loss, during the loss period. See Accounting Principles Board, Opinion No. 11 (1967), paragraph 44 and Financial Accounting Standards Board, Statement No. 96 (1987), paragraph 52. The tax effect of the NOL carryback (which is included in the determination of net income or loss) is based on income, or loss, reported for financial accounting purposes rather than for tax purposes. The refund of taxes expected as a result of the carryback is recorded as a current asset. Any difference between the tax loss and financial accounting loss carryback benefit is recorded in the deferred tax account. The shareholder allocation prototype would preclude corporations from recognizing the benefits of NOL carrybacks.

Because the shareholder allocation prototype eliminates the corporate AMT, it would reduce the provision for tax expense in those limited situations in which a corporation would otherwise calculate a hypothetical AMT liability. For financial accounting purposes additional tax expense is only provided with respect to the corporate AMT when the application of the AMT rules to financial accounting income would result in a hypothetical AMT liability, i.e., to the extent AMT relates to deferral items no additional tax expense is recorded for financial statement purposes. The corporate AMT also affects the financial statement allocation of tax expense among taxes currently payable and taxes payable at a future date. Accordingly, the shareholder allocation prototype also could affect these allocations.

3. Because both the dividend exclusion and shareholder allocation prototypes retain the corporate interest deduction, interest paid to tax-exempt organizations and foreign investors generally escapes U.S. tax, while corporate equity income distributed to such investors is subject to at least one level of U.S. tax. Achieving equal treatment of debt and equity under a shareholder allocation system would require a corporation to allocate its taxable income to both bondholders and shareholders each year,

whether or not interest or dividends were paid. A bondholder, like a shareholder, would be entitled to a credit for the corporate level tax on the income allocated, and the bondholder's basis would increase by the after-corporate tax amount of income allocated. Tax-exempt and foreign bondholders would not be entitled to claim refunds of tax credits. Unlike current law, which requires accrual-basis bondholders to include interest in income whether paid or not, a shareholder and bondholder allocation system might limit bondholders' interest income to the amount of the corporation's earnings.

Such a system would require rules for allocating corporate earnings to classes of debt as well as stock. The allocation rules in such a system should provide that earnings would be allocated first to interest payable or accrued on debt, and any remaining income would then be allocated to equity. One method for allocating income to traditional debt instruments would determine the maximum amount of income to be allocated to a given class of debt based on the current law rules for accrual-basis taxpayers (or for holders of bonds with original issue discount). Available earnings could then be allocated to each class of debt according to its priority, i.e., first to senior debt, then to senior subordinated debt, and then to subordinated debt. For example, assume that a corporation has $100 of earnings and three classes of debt. The first class of debt is bank debt, senior to the other two classes. The second and third classes are of equal priority. The interest accruing on the bank debt is $80; the interest accruing on the second class is $30; and the interest accruing on the third class is $10. Of the corporation's $100 of earnings, $80 would be allocated to the bank debt. The remaining $20 would be allocated proportionately between two classes of junior debt, so that $15 (or $20 multiplied by $30/$40) would be allocated to the second class, and $5 (or $20 multiplied by $30/$40) would be allocated to the third class. No earnings would be allocated to equity.

4. For a more detailed examination of problems involved in administering a widely held passthrough entity, including reporting issues, allocating items (such as built-in gain on contributed property) to members, and collection issues, see Department of the Treasury, Widely Held Partnerships (1990). Proposals are pending in the Congress to modify the conduit treatment of certain large partnerships. Under H.R. 2777 and S. 1394, 102d Congress, 2d Session (1991) the income of partnerships with at least 250 partners would be consolidated at the partnership level, resulting in a reduction in the number of separate items that would be reported to partners. Audit adjustments would result in a single, current year adjustment to partnership income, rather than adjustments to the returns of prior year partners. Under these bills, the tax administration of large partnerships would move toward an entity approach and away from the aggregate approach that dominates current law partnership rules.

In 1966, Canada's Carter Commission recommended a modified shareholder allocation integration system, but Canada did not adopt the recommendation. See Royal Commission on Taxation (1966). Similarly, the United States did not adopt the Blueprints proposal for a shareholder allocation integration system. In 1971, the Federal Republic of Germany's Tax Reform Commission rejected a shareholder allocation integration system because of administrative complexity. See Gourevitch, (1977), pp. 48-54. In addition, other countries have implicitly rejected shareholder allocation integration by adopting distribution-related integration systems, although most countries have passthrough entities that are taxed under a shareholder allocation integration approach.

5. For ease of computation, the discussion and examples in this chapter use a 31 percent corporate tax rate. The shareholder allocation prototype could retain the current 34 percent corporate tax rate but provide credits to shareholders at a 31 percent rate if maintaining the credit rate differential were desirable or necessary. The revenue estimates set forth in Chapter 13 assume a 34 percent corporate rate. Maintaining the corporate tax rate at 34 percent would require an adjustment in the amount of tax passed through to shareholders to allow shareholders a tax credit no greater than the maximum 31 percent individual rate. For example, if a corporation reported $100 of taxable income and owed $34 of tax, only $31 of tax would be passed through to shareholders. Retaining the rate differential would necessitate numerous calculations to transform corporate level preferences into shareholder level preferences; for example, if a corporation also had a $10 low-income housing credit, the shareholders should be entitled only to 31/34 of the credit.

6. The additional economic income sheltered by the credit, absent an upward adjustment of the shareholder's basis, will be taxed upon distribution by the corporation or sale of the shareholder's stock.

If the corporation had a $40 credit, shareholders would be allocated $31 of tax credits, and the $9 excess credit would be carried forward at the corporate level to the extent permitted under the Code. As discussed above, a shareholder with tax liability less than the amount of credit allocated to him could use excess credits against other income. As in the imputation credit prototype discussed in Chapter 11, consideration might be given to providing a carryforward at the shareholder level for unused credits. See Chapter 11, note 33.

7. Example. A corporation earns $100 of taxable income and pays $31 of corporate tax. The corporation's shareholders increase their basis in their stock by $69, the after-tax income of the corporation. This achieves the same result as a partnership that earns $100 of taxable income and distributes $31 in cash to partners to pay the tax.

8. Because the shareholder allocation prototype treats distributions first as a nontaxable return of capital to the extent of shareholder basis and second as capital gain to the extent of any excess over basis, the earnings and profits rules are not needed. Compare note 14, below.

9. To mitigate somewhat the effect of eliminating loss carrybacks, consideration might be given to extending somewhat the carryforward period, for example, from 15 to 18 years, so the total period in which corporate losses could be used would not be reduced under shareholder allocation.

10. Corporations with more complicated capital structures may require more complicated allocation provisions. See Section 3.F.

11. While noting that corporate level payment would facilitate payment of tax, Blueprints did not include such payment in its model system. See Blueprints, pp. 73-74. Compare IRC § 1446, which requires withholding by partnerships on income that is effectively connected with a trade or business in the United States and that is allocable to a foreign partner.

12. If passthrough of losses were permitted, corporate losses, like partnership and S corporation losses, could be used by shareholders to the extent of share basis. Losses in excess of share basis might be carried forward at the shareholder level. See IRC § 704(d).

13. One method for eliminating most preferences would require corporations to allocate AMTI, rather than taxable income, to shareholders. Each corporation would thus impute to shareholders the full amount of both taxable and preference income (at least to the extent preference items are included in AMTI), regardless of whether the corporation was subject to the AMT.

> Example. Assume that a corporation has $100 of taxable income and $30 of tax-exempt interest as its only preference item. The corporation would not be subject to the AMT, because the tentative AMT ($26) would not exceed the regular corporate level tax ($31). Nevertheless, the corporation would allocate $120 of income among its shareholders.

Under this approach, corporations would continue to pay corporate level tax as under current law, at either the regular or AMT rate, whichever is applicable. Shareholders would be entitled to credit both corporate level tax and AMT but would not be entitled to credit corporate tax to the extent it was offset in later years by the AMT credit.

The following example illustrates this method. The example assumes a 31 percent corporate and shareholder rate and a 20 percent corporate AMT rate.

	Year 1	Year 2	Year 3
Corporate Level Tax Calculation			
Corporate taxable income	$100	$100	$164
Corporate preference income	200	0	0
AMTI	300	100	164
Tentative AMT	60	20	33
Regular tax	31	31	51
AMT	29	0	0
AMT credit	0	11	18
Net corporate tax payable	60	20	33
Shareholder Level Tax Calculation			
Shareholder income	$300	$100	$164
Shareholder tax	93	31	51
Credit for corporate taxes paid	60	20	33
Net shareholder tax payable	33	11	18

In this case, a total of $175 of tax has been paid on $564 of economic income (a 31 percent rate).

This approach would effectively eliminate corporate level preferences, whether or not distributed, by taxing corporate preference income currently at shareholder rates. A shareholder in the 31 percent bracket would generally be liable for additional shareholder level tax to the extent that corporate AMTI exceeded corporate taxable income. Thus, corporate level preferences essentially would be taxed the same as corporate level taxable income, unless the absence of a corporate level

tax were significant. For example, a tax-exempt shareholder would not owe additional shareholder level tax, with the consequence that allocated preference income would be tax-exempt (except to the extent of the corporate AMT).

14. The following approach would tax preference income to shareholders only upon a distribution or a sale of stock. Corporations would track taxes paid, which would include payments of regular tax and AMT, as well as any AMT credits for AMT paid in prior years. An amount of deemed income equal to the amount of income that would give rise to the actual amount of corporate tax paid if tax had been imposed at a 31 percent rate would be allocated among shareholders. Thus, each $1 of regular tax or AMT would give rise to $3.23 of deemed income ($1/.31). Shareholders would report the deemed income and would be entitled to a credit for corporate taxes paid. Because this approach treats the amount of income that would be allocated to shareholders as if it had been taxed at the maximum corporate rate, no shareholder would owe additional tax on corporate level preferences currently and lower bracket shareholders could use excess credits to offset other tax liability. Share basis would increase by the amount of deemed income reported to the shareholder, net of the credit for taxes paid.

The following example compares the treatment of two corporations, only one of which, corporation B, is an AMT taxpayer. It assumes a 31 percent corporate rate and shareholder rate and a 20 percent AMT rate.

	Corporation A	Corporation B
Corporate Level Tax Calculation		
Corporate taxable income	$645	0
Corporate preference income	350	$1,000
Regular tax	200	0
AMT	0	200
Total corporate taxes paid	200	200
Shareholder Level Tax Calculation		
Shareholder income	$645	$645
Shareholder tax	200	200
Credit for corporate taxes paid	200	200
Net shareholder tax payable	0	0

Under this approach, corporations with significant preference income would pay tax at corporate AMT rates, but no additional shareholder level tax would be imposed currently. Additional shareholder tax would be collected only when preference income is distributed or shares are sold. Tax would be collected at that time because share basis is increased only by the amount of the deemed income. Thus, if a corporation has income that is taxed at less than a 31 percent rate, the shareholders' aggregate basis in their shares will be less than the corporation's aggregate earnings available for distribution. When distributions exceed shareholder basis (or when shares are sold for amounts in excess of basis), additional shareholder tax will be paid.

Example. A corporation has $100 of assets and a single shareholder with a stock basis of $100. During the year, the corporation earns $200 of preference income and pays AMT of $40. The corporation allocates $129 ($40 ÷ .31) of income and $40 of tax credit to the shareholder. The shareholder's basis increases to $189 ($100 original basis plus ($129−$40)). The corporation has $260 of assets available for distribution. If the corporation distributes $260 to its shareholder, the shareholder will recognize gain of $71, the amount of preference income not previously taxed at 31 percent.

Under this approach, distributed preference income is generally taxed at capital gain rather than at ordinary income rates, because distributions in excess of basis are treated as gains from the sale of stock. In contrast, under current law and under distribution-related integration, only retained preference income (which increases share value) is taxed as capital gains, while distributed preference income is taxed as ordinary income.

In contrast to the treatment of dividend distributions under current law, this method treats distributions first as a return of capital, so preference income is not taxed until share basis is exhausted. This stacking order is not consistent with the dividend exclusion or CBIT prototypes or the imputation credit prototype, described in Chapter 11, which require that distributions in excess of fully-taxed income be treated as taxable distributions of preference income before they are treated as returns of the shareholder's investment. It is possible, however, to conform the stacking order in the shareholder allocation prototype to the stacking in those prototypes. To do so, a corporation would be required to maintain an accumulated earnings and profits account (essentially under the rules of current law). Within the earnings and profits account, the corporation

would maintain a subaccount for fully-taxed earnings and profits (computed by tracking taxes paid, as in the EDA). See Section 2.B. Distributions in excess of the fully-taxed earnings, up to the amount of earnings and profits, would be treated as taxable dividends, rather than a return of the shareholder's investment.

15. Example. Assume that a shareholder has a basis of $10 in stock of a corporation. If the corporation earns $100 of taxable income and receives $50 of tax-exempt bond interest in year one, the corporation would pay $31 in tax. The shareholder would include $100 in income and would be entitled to offset the $31 shareholder tax by the $31 credit for corporate level tax. The shareholder's basis would increase by $119 (the tax-exempt interest income plus the taxable income, reduced by the amount of taxes paid). Thus, the corporation could distribute its net cash of $119 without giving rise to shareholder level tax. This basis adjustment differs from the $150 adjustment that would be made in a partnership because of the $31 of tax collected at the corporate level.

16. Example. Assume that a shareholder invests $100 in stock of a corporation. The corporation invests the $100 of contributed capital in an asset that costs $100. Assume that the corporation earns $100 and is entitled to expense the asset in year one, rather than depreciating it over its economic life of three years. The deferral preference will reduce the corporation's income subject to corporate level tax in year one to $0. In years two and three, however, the preference turns around, because the corporation will have more income than it would have if the asset had been depreciated over 3 years. Thus, the corporation's and the shareholder's income in years two and three will be higher.

17. Example. A corporation's only income is $100 of tax-exempt interest on bonds described in § 57(a)(5). Thus, its taxable income is $0 and its AMTI is $100. The corporation pays $20 of AMT. Assume that an individual taxpayer with a 31 percent marginal tax rate holds all the stock of the corporation and has no other income. Disregarding AMT exemption amounts, the shareholder would include the $100 of corporate AMTI in his own AMTI, and thus would owe individual AMT of $24. The shareholder could then credit the $20 of corporate AMT against his own AMT liability, resulting in a net AMT liability of $4.

If the shareholder had other income, e.g., $100 of wage income, the shareholder would pay $31 of regular tax and $17 of AMT ($200 AMTI × .24 − $31). The $20 of corporate level AMT paid at the corporate level would be creditable to reduce the total tax due from the shareholder to $28. The shareholder would have an AMT credit of $17 to use against future regular tax liability but no corporate level AMT credit would be allowed.

18. Permitting shareholders to credit corporate AMT paid against their regular tax liability without including any amounts in shareholder AMTI, in effect, would refund the corporate AMT to taxable shareholders.

Example. The facts are the same as in the example in the preceding footnote. The 31 percent bracket shareholder also has $100 of wage income. If the AMT paid at the corporate level were creditable against regular tax, but no AMTI were imputed to the shareholder, the shareholder would pay only $11 of regular tax.

19. One approach would continue to impose the corporate AMT without any current credit to shareholders for corporate AMT paid. Shareholders would benefit from corporate AMT payments only when the corporation made the AMT credit allowed by IRC § 53 to reduce a subsequent year's regular tax liability. The AMT credit would be passed through to shareholders like other credits. This rule would, however, deny integration benefits to shareholders of corporations that are chronic AMT taxpayers, because those corporations may never use their AMT credits. This system also would require modifications to the shareholder basis rules to decrease share basis to reflect the payment of a noncreditable, nondeductible tax.

An alternative rule would impute to shareholders, in addition to the corporation's taxable income, an amount of income based on the corporate AMT paid, and allow shareholders to credit the corporate AMT against their regular tax. The additional income imputed would equal the amount of corporate AMT paid, grossed up at 31 percent.

Example. The facts are the same as in the examples in the preceding two footnotes. Instead of including corporate AMTI in shareholder AMTI, the corporation would allocate $64.52 of additional income ($20/.31) to its shareholder. The shareholder would then credit the $20 of corporate AMT against his regular tax liability. Thus, the shareholder's total taxable income would be $164.52; total tax liability would be $51; and the shareholder would be allowed to credit the corporate AMT to reduce the tax due to $31.

This approach is similar to the method described in note 13. Unlike that method, however, this rule imputes a grossed-up amount of income to shareholders only to the extent of corporate AMT paid. As a consequence, it produces erroneous basis

adjustments in the case of deferral preferences, because deferral preference gives rise to partial basis when AMT is paid and subsequently gives rise to the full amount of basis when the preference turns around and generates regular taxable income. The basis adjustments could be corrected by continuing to calculate basis adjustments based on grossed-up taxes paid (rather than taxable income allocated to shareholders). Such alternative basis adjustments would require complex rules, complicated information reporting, and would create basis adjustments the timing of which differ from the timing of income passed through to shareholders.

20. S corporations allocate income items pro rata. An S corporation allocates to each share of stock exactly the same amount of each item arising in a taxable year. This system is simple and administrable; it works well for S corporations because they may not have more than one class of stock. IRC § 1361(c)(4) permits classes of stock in an S corporation to have different voting rights, but other differences generally are prohibited. Thus, the system achieves simplicity by requiring all the stock of an S corporation to possess similar economic rights. An integration proposal that limits all corporations to a single class of stock, however, is neither feasible nor economically desirable. The variety of existing corporate capital structures precludes serious consideration of such a system.

21. IRC § 704(b).

22. Treas. Reg. § 1.704-1.

23. The complex capital account maintenance rules contained in the regulations under IRC § 704(b) illustrate the variety of issues that would have to be addressed. An alternative approach would look to IRC § 305 to impute income to a shareholder whose proportionate interest in the corporation increases as does the holder of class B stock in the example in the text. We do not explore the implications of such an approach.

24. Example. Two shareholders form a corporation and contribute $100 each. One shareholder receives preferred stock with a liquidation preference of $100 and a return of 10 percent. The other shareholder receives common stock, which is entitled to the remaining income and assets. Assuming the corporation makes no cash distributions, corporate income would be allocated as follows:

		Allocations		Year-End Capital Accounts	
Year	Corporate Income	Preferred	Common	Preferred	Common
1	50	10	40	110	140
2	50	11	39	121	179
3	50	12	38	133	217

Under the terms of the preferred stock, the liquidation preference of the preferred stock increases each year as its capital account increases. In year one, the preferred shareholder is treated as if it received $10 and purchased an additional $10 of preferred stock. As a consequence, the preferred shareholder is allocated $11 in year two (10 percent of $110 of preferred stock). If the corporation is liquidated at the end of year three, the corporation has total assets of $350 and the preferred stock has a capital account (liquidation preference) of $133. The common stock would thus receive the remainder of the assets, or $217.

As the text notes, capital accounts would be adjusted to reflect corporate losses. Assume that the corporation is not liquidated until year four and there is a $100 loss in year four, so the corporation's assets are reduced to $250. In that case, no income would be allocated to either shareholder in year four, but the $100 loss would reduce the common shareholder's capital account to $117. Upon liquidation at the end of year four, the preferred shareholder would receive $133 and the common shareholders would receive $117.

25. The full integration proposal in Blueprints used an annual record date method and designated the shareholders on the first day of the taxable year as the shareholders of record to avoid "trafficking" in shares of loss corporations at year end. Blueprints, pp. 70-71, rejected a "last day" rule because, at year end, the market would have information indicating that the corporation would incur a tax loss for the year, and shares could then be sold to high-bracket taxpayers to whom the loss would be most useful. Because the shareholder allocation prototype does not permit the passthrough of losses to shareholders, loss trafficking is not an issue. The quarterly record date approach also minimizes tax-motivated year-end trading to capture credits for corporate taxes paid by limiting the benefit of year end ownership to one quarter of income and its proportional share of tax.

26. It may be desirable to allow (or require) corporations to close their books under certain circumstances. For example, a seller of a majority stock interest in a corporation may wish to ensure that income generated by activities after the sale will not be allocated to her. Similarly, the government could have an interest in requiring closing of the books after extraordinary corporate events to assure that net income and loss are allocated to the appropriate shareholders.

27. The effect of A's loss is to defer taxation of $10.35 of corporate income until the purchaser sells his stock. If A can fully use the capital loss, A's loss offsets the tax on $10.35 of corporate income. The purchaser, however, has a basis of $144.85 ($117.25 plus $27.60) in the stock of a corporation having assets with a value of $155.20. The purchaser thus has built-in gain of $10.35 in his stock.

28. The Code provides that a partnership's taxable year closes with respect to a partner whose entire interest is sold. See IRC § 706(c). If a partner's interest varies during a year, the Code simply provides the general rule that tax items are to be allocated to take into account this variation. Specific rules are provided for a few items of cash basis taxpayers, such as interest and taxes, which must be allocated on a per day basis throughout the taxable year. See IRC § 706(d)(2).

29. In that case, each prior quarter's income would be unaffected by subsequent events, and each future quarter's income would be allocated to the purchaser.

30. We also rejected the alternative of allocating a corporation's income on a per share per day basis throughout the taxable year. Although current law employs this system for S corporations, which must allocate income among stockholders on a strict pro rata basis, including daily allocation of income where there has been an ownership change, we believe that this system could not successfully be applied to large corporations with publicly held stock in which there is frequent trading. Publicly traded partnerships are widely held, publicly traded entities that are required under current law to allocate certain items among partners on a per day approach. However, these partnerships typically adopt conventions to minimize the difficulties of tracking frequent changes in ownership, for example, by allocating each month's share of partnership income to the partner holding the partnership unit on the first day of the month. Compared to publicly traded partnerships, publicly held corporations have more shares of stock outstanding, and the stock is traded more frequently; for example, trading of the most actively traded stock can exceed one million share per day. A per share per day approach would require tracking of many millions of transfers during a year, and therefore a daily allocation method would be impractical for publicly traded corporations.

31. The Blueprints system is one example. That system did not include a corporate level tax, taxed capital gains at ordinary income rates, and permitted unlimited use of capital losses against ordinary income. See Blueprints, p. 77. Accordingly, the Blueprints system permitted a shareholder of record who sold stock during the year to calculate gain or loss calculated by reference to his basis at the beginning of the year, based on the observation that the allocation of current year income would not affect the difference between the sale proceeds and his basis as of the date of sale. The corporate income or loss that he would have to report as the shareholder of record would be exactly offset by a corresponding basis adjustment. See Blueprints, pp. 71-72.

The results are somewhat different under the shareholder allocation system, which retains a corporate level tax. The introduction of a corporate level tax means that allocations of taxable income increase share basis but do not create any additional shareholder level tax liability (because the corporate tax rate is at least equal to the maximum shareholder rate). For example, under the Blueprints system, an unexpected increase in allocable earnings of $100 would increase a selling shareholder's taxable income by $100 but would increase basis (and reduce gain, or increase loss, on sale) by the same amount. Ignoring differences in character (which may have significant consequences), the shareholder's total income would be the same. Under the shareholder allocation prototype, however, an unexpected $100 increase in earnings would result in an allocation of $100 of earnings and $31 of tax credits. If this increase occurred for a period prior to the period in which the sale took place, e.g., an unexpected increase in earnings for the first quarter with respect to stock transferred in the second quarter, the withholding credit will be available to the selling shareholder. The parties to the transfer would need to estimate the potential for material changes in earnings on pricing the stock. Blueprints acknowledged that the addition of a corporate level tax complicates calculation of gain on sale. Blueprints, p. 74.

The current treatment of capital gains and losses would complicate calculations under a record date system. A shareholder who sold stock with a basis of $100 for $150 might not be indifferent between $50 of capital gain (if gain were calculated at the time of sale) and $75 of ordinary income and a $25 capital loss (if calculation of gain were deferred and the corporation earned $75 for the year).

32. Where corporate tax is imposed at a rate greater than or equal to the maximum individual rate, the government does not suffer from delay in attributing income to the proper corporate entity. An upper tier corporation that held stock in a lower tier corporation might be required to report its income from the lower tier corporation with a one year delay. Thus, if an

upper tier corporation purchased stock in another corporation during year one, the upper tier corporation would report no income from the investment in year one. The upper tier corporation's share of the lower tier corporation's year-one income would be reported in year two. The government's interest would not suffer, as the lower tier corporation's income would have been subject to tax at the corporate rate in year one. The upper tier corporation and its shareholders would, however, suffer a detriment to the extent that the corporate rate exceeds shareholder rates and shareholders would have been entitled to use excess credits for corporate taxes paid. In that case, the upper tier corporation's shareholders have, in effect, made an interest-free loan of the excess credits to the government.

Such a system could be restricted to situations where the upper and lower tier corporations have identical taxable years. If taxable years differ, the upper tier corporation would report the lower tier income in its taxable year in which the lower tier corporation's taxable year ends. If two corporations own stock in each other, this system could result in a continuous delay in proper attribution of the income. Under such a system, taxpayers would have an incentive to structure their investments to minimize relationships that cause detrimental reporting delays. To the extent such arrangements are impractical, however, a shareholder allocation system would treat intercorporate investments more harshly than direct investment.

33. The pending tax simplification bills would adopt a similar approach for large partnerships. See The Tax Simplification Act of 1991, H.R. 2777 and S. 1394, 102d Cong., 1st Sess. (June 26, 1991). See also U.S. Department of the Treasury, Widely Held Partnerships (1990).

34. This problem is closely analogous to the problem of extending preferences to shareholders, discussed in Section 3.E.

35. Example. A U.S. corporation's only income is a dividend from a foreign subsidiary. Under IRC § 902, the corporation includes $100 in income and receives a credit for foreign taxes paid of $40. Under the foreign tax credit limitation rules of IRC § 904, the corporation's foreign tax credit is limited to $31. The corporation's sole shareholder is Shareholder A who has a marginal tax rate of 15 percent and wage income of $100. Without foreign tax credit limitation rules at the shareholder level, Shareholder A will treat $31 as a credit for taxes paid and use the excess credit of $16 to offset all tax due on his wage income.

Section 11.D discusses the feasibility of using a shareholder level exclusion of foreign source income to avoid the application of IRC § 904 at the shareholder level if foreign taxes were treated like U.S. taxes under the imputation credit prototype.

Chapter 4

1. Although there are no existing models of this prototype, others have suggested a similar approach using a bondholder credit. See, e.g., Steuerle (1989) (describing a "simplified integrated tax" that would be withheld by corporations at the maximum individual or corporate rate); Seidman (1990) (describing an FDIC proposal to require corporations to withhold 34 percent of all their dividend and interest payments and require recipients to report the grossed-up amount of the distributions and claim a credit for the tax withheld by the corporation); H.R. 4457, 101st Cong., 2d Sess. (1990) (introduced by Congressman Vander Jagt, and proposing an approach similar to the FDIC proposal outlined by Mr. Seidman). For proposals that resemble CBIT even more closely, see Jacobs (1987) (describing a 28 percent "single business tax" on capital income that would be imposed by disallowing business interest deductions and excluding interest and dividends from investors' taxable income); Bravenec (1989) (describing a "nontraditional approach to integration" that would deny corporations interest deductions and exclude from income of investors dividends and interest received from corporations).

The financial accounting ramifications of CBIT are, in many respects, the most direct of all the integration prototypes. The nondeductibility of interest expense would increase corporations' income tax burden, thereby increasing the provision for income taxes and reducing earnings per share. Generally, we would expect an increase in the provision for income taxes and a reduction in earnings per share for net borrowers. In the rare case of certain net lenders, the provision for income taxes could be reduced and earnings per share could be increased. Because nondeductibility of interest expense would increase taxes currently payable, CBIT also would serve to increase the reported current liability for income taxes and the cash flow requirements associated with this current liability. The recommended gradual phase-in of CBIT should allow for gradual changes in capital structures and enhance the comparability of interperiod financial results.

A less obvious financial accounting effect of CBIT arises if a compensatory tax is imposed. The standards for accounting for income taxes generally require corporations to recognize as income tax expense both the taxes currently payable and the taxes that are payable during a future period but are, nonetheless, associated with earnings during the current period. See Accounting Principles Board, Opinion No. 11 (1967), paragraph 34, and Financial Accounting Standards Board, Statement

No. 96 (1987), paragraph 7. Under these standards, income tax expense recognized by a CBIT entity would include the potential compensatory tax liability that is associated with preference income which is earned and retained by the entity. Thus, the compensatory tax could serve to further increase the provision for income taxes. The financial accounting for a compensatory tax has never been formally considered, however, and it is conceivable that the financial accounting authorities might permit corporations to disregard potential tax expense associated with future compensatory taxes provided the corporation's earnings distribution policy suggests that the likelihood of a distribution of preference income is remote. The Accounting Principles Board has adopted such a position with respect to the provision for taxes that may arise with respect to distributed earnings of subsidiaries, e.g., foreign subsidiaries or subsidiaries that are not consolidated for tax purposes. See Accounting Principles Board, Opinion No. 23 (1972), paragraphs 9-14.

2. See Chapter 10.

3. CBIT is related to, but not identical with, a bondholder credit system that taxes interest income at the debtholder level through an imputation credit system. CBIT differs from a bondholder credit system where the borrower and lender have different marginal tax rates. See Section 11.H, which describes a bondholder credit system and discusses the differences between that system and CBIT.

4. See Section 13.H. If gains on sale of CBIT equity and debt are not subject to tax, losses on such securities also would not be allowed. Given the difficulty of the analysis of capital gains in the context of integration (see Chapter 8), we simply note here that the CBIT prototype would be revenue neutral at a 31 percent rate with full exclusion of capital gains and losses on sales of CBIT equity and debt at the investor level.

5. See Sections 4.F and 6.D.

6. Compare Sweden's flat rate tax on capital income, adopted in 1991 as part of a comprehensive tax reform package. See Swedish Ministry of Finance (1991) and Lodin (1990). Under the new system, a flat tax rate of 30 percent applies to all capital income received by individuals, including dividends, interest, and capital gains. Earned income is taxed separately, at graduated marginal rates ranging from approximately 31 to 50 percent. Unlike CBIT, Sweden's flat rate tax on capital is not an integration proposal. Sweden generally retains the classical system of corporate taxation, taxing corporate income at a rate of 30 percent. The Swedish system provides a limited dividends paid deduction for new equity and a "tax equalization reserve" that reduces the effective tax burden on retained earnings to approximately 23 percent. Swedish Ministry of Finance (1991), p. 39.

7. A gradual phase-in also would provide an opportunity to evaluate the extent to which imposing one level of tax on interest paid to tax-exempt and foreign investors might induce those investors to change the composition of their portfolios or the level of their investment in U.S. business. Adjustments in the application of CBIT to these investors can be adopted to reduce such effects if undesirable portfolio shifts or changes in capital flows occur. See Section 4.F. Partial steps toward a CBIT regime that would narrow distinctions between debt and equity also are possible on a revenue neutral basis. See Section 6.D.

8. As recommended, the CBIT prototype can use a 31 percent rate—equal to the top individual marginal rate—rather than a 34 percent rate without losing revenue relative to current law. See Section 13.H.

9. Carrybacks would not, however, be permitted if they would create a negative balance in the EDA.

10. Fully-taxed income is determined in the same manner as under the dividend exclusion prototype. See Sections 2.B and 4.D.

11. Several nations have expressed concern about their increasing inability to tax capital income, and some interest has been shown in the adoption of a withholding tax of 10 to 15 percent on capital income, although concern over the potentially adverse implications of the unilateral adoption of such a tax has precluded general acceptance of such a tax. In 1989, the European Commission (EC) proposed a 15 percent withholding tax on savings bank and bond interest income earned by residents of the EC. This proposal, which would not have affected Eurobonds or residents of countries outside the EC, was not accepted, although an informal meeting of the Finance Ministers of the member countries supported a withholding tax on capital income if such tax also were supported by the United States, Japan, and other countries. See Turro (1989). EC Tax Commissioner Madame Scrivener subsequently proposed a 10 percent tax on interest income, but this proposal also was not generally accepted; see Goldsworth (1990). Since then, Madame Scrivener has continued to express the view that a general withholding tax on interest income is the best solution to the problem of tax avoidance in a world of increased capital mobility. See Nagle (1990) and *Daily Tax Report* (November 8, 1991).

12. This Report explores CBIT as an integration prototype directed to the taxation of equity and debt income generated by businesses. The CBIT approach, however, might be extended to other types of interest income. Such an expansion of CBIT might provide a means of taxing all interest income at a uniform rate. Economic efficiency suggests that taxing capital income at a uniform rate might improve welfare. While an expanded CBIT approach is beyond the scope of this Report, we note that it raises difficult issues.

Home mortgage interest would be one important issue in considering an expanded CBIT regime. Under current law, home mortgage interest generally is deductible by the payor and includable in the income of the recipient. While the basic CBIT prototype retains the current law treatment, an expanded CBIT regime might subject home mortgage interest to CBIT. Subjecting home mortgage interest to the CBIT rules would ensure that one level of tax is collected on home mortgage interest. Under current law, home mortgage interest paid to tax-exempt or foreign investors (who may hold mortgage passthrough certificates) escapes the U.S. tax base entirely. Depending upon the level of interest rates following adoption of an expanded CBIT regime, the average homeowner with a mortgage might be better off with CBIT treatment than with the deductibility of current law.

In addition, if all capital income were taxed at a single rate at the payor level, the distinction between interest and other types of capital income that may have a significant interest component would become more important. "Identifying Disguised Interest" in Section 4.G discusses the implications of CBIT for the current law distinction between true leases that are treated as leases and financing leases that are treated as loans. That section reflects our judgment that, under the CBIT prototype, no important changes in current rules for distinguishing between interest and other types of capital income are necessary. In an expanded CBIT regime, however, the pressure on the line between interest and other capital income would be greater.

13. Interest and dividends received from a nonCBIT business would be included in the taxable incomes of individual and business investors, and capital gains realized on the disposition of interests in nonCBIT businesses would be taxable without regard to any change due to CBIT.

14. We anticipate that entities might move freely from CBIT to nonCBIT status based on annual gross receipts, i.e., a business which had gross receipts of $75,000 in year 1, $125,000 in year 2, and $75,000 in year 3 would report its income under current law provisions in years 1 and 3 and file a CBIT return in year 2. CBIT tax paid in year 2 would allow payment of tax-free distributions attributable to the taxed amounts in year 3 and later nonCBIT years. The impact of year to year changes would cause some complexity and would cause a rate notch effect as an entity moves in and out of CBIT status. An alternative would allow organizations that generally meet the gross receipts test to remain nonCBIT entities until they have exceeded the floor for several years.

15. If the lower bound were higher, an aggregation rule probably would be required. The least complicated approach would require individuals with more than a threshold amount, e.g., $100,000, on Schedules C and K of their Forms 1040 to pay tax at a schedular rate of 31 percent on the excess. While this approach would inhibit multiplication of entities to avoid the CBIT loss limitation, it would not be effective to prevent use of multiple entities to evade the CBIT interest deduction disallowance rule. A refinement could require all nonCBIT small entities to report to their shareholders and partners their deductions for business interest paid. (Individual proprietors would, of course, know this amount for Schedule C activities.) Individuals could then be required to add these amounts to the income reported on Schedules C and K in computing the schedular tax described above.

16. An alternative would adopt graduated CBIT rates to reduce the impact of CBIT on small businesses. Because the 31 percent CBIT rate equals the top individual rate, this would have the effect of imposing CBIT at rates identical to those at the individual level. The principal disadvantage of this approach is that it would require complex rules to combat multiple use of the graduated rates by common owners. Compare IRC § 1551 (denying the benefit of graduated rates to corporations under common control).

Another alternative that we rejected as unduly complex would subject all corporations and unincorporated businesses to CBIT, but tax all income of owner-managers at their personal rates rather than at the CBIT rate. Once owner-managers have been identified, the business would proceed to calculate its CBIT tax, excluding the share of profits and other income attributable to the owner-managers (whether that income is called salary, bonuses, partnership income, dividends, or interest) from the CBIT income of the business. The owner-managers then would include these amounts in their personal income when they calculate their taxes. This alternative, however, would introduce a set of complexities that a receipts-based exception avoids. One example would be the need to separate all interest income and expense items between their business and personal components. Some taxpayers will see this task as unnecessarily difficult, while others will see it as an opportunity for tax planning. For example, a proprietorship operated out of the proprietor's home should bear a (nondeductible) portion of the home mortgage interest expense. Additional rules would be needed to address these problems. Taxpayers would likely find the rules to be complex, arbitrary, and unfair.

The criteria for being considered an owner-manager might be similar to the requirements for "material participation" under the passive loss limitations of IRC § 469. Another possible set of criteria would treat as owner-managers all individuals who report net earnings from self-employment under IRC § 1402. (Net earnings from self-employment, as defined in IRC § 1402(a), would have to be modified for CBIT purposes by adding back all the capital income that is excluded from the current self-employment tax. See, e.g., IRC § 1402(a)(1) and (2), which exclude most rents, dividends, and interest from self-employment income.) A third possibility would follow the concept in IRC § 911(d)(2)(B), which identifies individuals who are engaged in trades or businesses in which both personal services and capital are material income-producing factors. That identification also was used to apply the maximum tax on earned income of former IRC § 1348, repealed in 1981, and the IRS and the courts developed a considerable body of law on whether services and capital are material income-producing factors in a given trade or business.

17. On the other hand, imposition of tax on distributed preference income (at either the corporate or shareholder level) may be viewed as retaining, in small part, the current system's bias against dividend distributions. See Chapter 5.

18. See Section 2.B. To illustrate the functioning of such a mechanism under CBIT, assume that a corporation earned $100 of taxable income and $100 of preference income. The corporation would pay tax of $31 and would add $69 of fully-taxed income to its EDA. The balance in the account would translate into $69 of excludable distributable income. Thus, if the corporation distributed $75 during the year, $6 would be deemed made from preference income and would be includable in the investor's taxable income.

19. Other solutions may be possible. For example, a compensatory tax could be imposed, but a tax credit like that described in Section 4.F could be provided to tax-exempt and foreign investors. A compensatory tax would raise sufficient revenue to allow a refund of up to 50 percent of entity level taxes paid to tax-exempt and foreign investors. We expect that such a credit would significantly reduce the distortion in payout decisions the compensatory tax would create. As Section 11.B discusses, the compensatory tax creates a real increase in the tax burden on distributed preference income because we do not recommend refunding it to tax-exempt and foreign investors. If the compensatory tax were completely refundable to such investors, the amount of tax collected from investments by those investors would remain the same, and one would expect businesses and investors to adjust, in the long run, to what is merely a change in the collection mechanism without an additional burden. A partial refund of entity level tax would mitigate the distortions created by a compensatory tax. See also Section 6.D.

20. If a compensatory tax is adopted in CBIT, consideration could be given to allowing payments of compensatory tax to be credited against subsequent regular tax liability. Such a rule would allow the most taxpayer-favorable stacking of taxable income and preference income earned in different years. However, the existence of excess compensatory tax carryforwards—like excess ACT accounts in the U.K. system—may create "trafficking" concerns. See American Law Institute, Reporter's Memorandum No. 3 (1991).

> Example. A corporation earns $100 of preference income in year 1 and distributes $69, incurring $31 of compensatory tax. In year 2, the corporation earns $100 of taxable income and owes $31 of tax, which is offset by the previous year's payment of compensatory tax. The corporation now has a zero EDA and will owe $31 of compensatory tax when it distributes the second year's income.

If compensatory tax is not creditable against regular tax liability, the corporation would owe $31 of regular tax in year 2 but would have a $31 EDA. This is the approach we generally follow in discussing a compensatory tax under CBIT.

21. The CBIT prototype uses the imputed interest and OID rules to distinguish payments of interest from payments of principal; similar rules may be required for preferred stock. See "Current Law Interest Deduction Limitations Under CBIT," in Section 4.G. These rules are necessary to ensure that payments representing a return of debt or preferred stock capital do not reduce the EDA and are not subject to compensatory tax or investor level tax.

The role, if any, of the current earnings and profits rules requires reconsideration under CBIT. Although earnings and profits could be computed under CBIT principles, i.e., without an interest deduction, it is unclear whether those rules would be necessary or appropriate as an additional (or alternative) mechanism for identifying payments that represent a return of equity or debt capital. The dividend exclusion prototype, which applies only to stock, retains the earnings and profits rules. See Section 2.F.

22. The tax paid would result in an addition to the EDA and would ensure that the income would not be taxed again when redistributed.

23. It may be desirable to provide a 100 percent deduction without regard to the degree of affiliation between the payor and the recipient. Although the dividend exclusion prototype retains current law, that prototype applies only to equity. Under CBIT, which applies to both debt and equity, there seems to be no reason to accord a larger deduction to a related creditor than to a portfolio creditor, and maintaining parity between debt and equity requires the same treatment for shareholders.

24. Imposing a 31 percent tax on all individual income in excess of $100,000 reported on Schedules C and K of Form 1040 might be required to achieve these simplifications. See note 15 supra.

25. Historically, the corporate and individual minimum taxes were enacted in response to public perceptions that corporations and individuals with substantial economic income were not paying any income tax. Although CBIT may result in some taxpayers not writing checks to the IRS (because most of their income is excludable CBIT interest and dividends), individuals do not in fact escape tax on interest and dividends paid by a CBIT entity, because the investors' income tax is prepaid at the entity level and at the CBIT rate (which is equal to the top individual rate and exceeds the individual AMT rate).

26. Other countries with integrated systems of corporate taxation typically treat foreign source income in a similar fashion; the domestic tax on foreign source income that is not initially collected because of foreign tax credits (or an exemption rule) is collected, at the shareholder's tax rate, when the foreign source income is distributed to resident shareholders. Collection of this tax is not considered inconsistent with income tax treaty obligations to grant relief for foreign taxes. If a compensatory tax were imposed under CBIT, the domestic tax would be collected at the 31 percent CBIT rate, rather than the rate paid by the shareholder on its other income.

27. See *U.S.* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989).

28. Under this approach, the CBIT prototype collects U.S. tax currently on foreign source income of a branch used to pay interest. We view this as the correct approach. Unlike other differences typically found between the U.S. and foreign computations of the foreign source income base (e.g., depreciation or inventory), the treatment of interest under CBIT would be a major systemic difference. The decision not to permit a foreign tax credit against the portion of a branch's foreign source income base used to pay interest can be analogized to placing such income in a separate limitation or "basket" under IRC § 904(d). Since the foreign jurisdiction can be expected never to impose tax on this income, it is appropriate to prevent the averaging of high foreign taxes imposed on other foreign source income against the "zero" rate of tax imposed on the income used to pay interest.

We recommend that the foreign tax credit limitation be computed as the lesser of (1) .31 times foreign source income computed with a deduction for interest expense allowable under foreign law and (2) actual U.S. tax liability. This approach has a disadvantage in that dividend income received by a U.S. corporation from a foreign subsidiary will be included in the foreign source income base without a reduction for interest expense allocable to the corporation's investment in that subsidiary, i.e., because that interest expense will not be deductible for foreign tax purposes. The resulting inflation of the limitation will permit the U.S. corporation to absorb excess foreign tax credits generated by non-dividend income.

An alternative approach would compute the foreign tax credit limitation by taking into account the interest expense that would be deductible and allocable to foreign source income under current law rules. See IRC §§ 861 and 864. Under this approach, the foreign tax credit limitation formula would be: .31 × (worldwide income) × (foreign source income/worldwide income), where worldwide income is reduced by interest expense that would be deductible under current law and foreign source income is reduced by interest expense that would be allocable to such income under current law. An obvious disadvantage of this approach is that it would require the retention of current law provisions that determine the deductibility and allocation of interest expense. On balance, the choice between these alternatives depends upon whether the complexities associated with retention of current law interest rules are more or less acceptable than the potential averaging that would arise from reliance on foreign law. See also Section 4.G.

29. Computation of the earnings of a foreign subsidiary without a deduction for interest might be considered appropriate on the ground that such earnings are calculated under IRC § 902 in order to determine the U.S. tax liability of the U.S. corporate shareholder (a CBIT entity), and not of the foreign subsidiary. In other words IRC § 902 deems the U.S. corporate shareholder to have earned the earnings used to pay the dividends it receives from the foreign subsidiary and to have paid the associated foreign tax. If this approach were adopted, an indirect credit could be granted for interest payments received by a 10 percent U.S. corporate shareholder from a foreign subsidiary. Compare IRC § 904(d)(3)(C). A U.S. corporate shareholder receiving both interest and dividends from a foreign subsidiary with no other creditor would then receive a full indirect credit for foreign taxes paid by the subsidiary. This would permit the use of foreign tax credits to shelter the interest income from U.S. tax, however, which, as discussed in the context of foreign branch income, we consider objectionable. Moreover, in cases where a foreign subsidiary paid interest to a creditor other than a 10 percent U.S. corporate shareholder, this approach would result in the stranding of foreign tax credits at the subsidiary level. Specifically, the computation of

foreign subsidiary earnings without an interest deduction would reduce the indirect credit available to a U.S. corporate shareholder with respect to dividends received from the subsidiary, i.e., because those dividends would represent a reduced proportion of a larger, hypothetical amount of subsidiary earnings. It would be impossible for the U.S. shareholder to obtain a credit for the full amount of taxes paid with respect to income distributed as dividends because a portion of such taxes would be deemed to have been paid on income paid out as interest to a third party creditor. This would be the case, even though the foreign subsidiary was not actually taxed on income paid out as interest, by virtue of the availability of an interest deduction for foreign tax purposes. To avoid this result, we have proposed that the earnings of a foreign subsidiary be calculated for IRC § 902 purposes with an interest deduction based on the interest expense claimed under foreign law.

30. In the case of foreign operations conducted through a foreign partnership, this may raise an issue of comparability with a foreign branch. This issue is discussed below at note 37.

31. Introduction of CBIT might induce some U.S. corporations to reorganize foreign branch operations as foreign subsidiaries. The nondeductibility of interest under U.S., but not foreign, tax law would effectively reduce the foreign taxes available to offset U.S. tax, thus providing greater incentives for operating in corporate form abroad in order to defer U.S. taxation.

32. The branch profits tax also would be repealed because, in the absence of a dividend withholding tax, it would no longer be needed to maintain parity between U.S. branches and U.S. subsidiaries of foreign corporations.

33. Significant exceptions to the portfolio interest exemption, i.e., interest paid to a foreign bank on a loan made in the ordinary course of business and interest paid to related foreign persons, give the United States some leverage to obtain withholding rate reductions in treaties negotiated under current law.

34. See IRC § 882(c) and Treas. Reg. § 1.882-5.

35. Note that the 30 percent withholding rate would perform a function here analogous to the 31 percent schedular tax discussed in note 15. Reduction or elimination of the 30 percent tax by treaty might encourage the use of multiple small business entities to avoid CBIT.

36. The term "nonCBIT debt" refers to debt issued by entities that are not subject to CBIT. NonCBIT debt includes Treasury securities, home mortgages (and mortgage passthrough certificates), debt issued by tax-exempt entities, and debt issued by foreign governments and businesses, all taxable to U.S. persons. State and local government debt is nonCBIT debt also; however, it would remain tax exempt to the extent provided in current law.

37. U.S. CBIT entities needing funds for foreign operations could borrow through foreign subsidiaries. Borrowing through a foreign branch would not be desirable, however. Because a foreign branch would be a component of a CBIT entity, it would not be permitted to deduct interest expense. Thus, the branch would probably find it advantageous to borrow in the United States (where its ability to pay excludable interest could be expected to produce a lower interest rate) rather than paying higher, nonCBIT interest rates that would be required to attract foreign lenders. An alternative would treat foreign branches as if they were foreign subsidiaries for CBIT purposes. Interest paid by a foreign branch would then be deductible by the branch and taxable to the lender. Rules similar to those of IRC § 861(a)(1)(B)(i) (providing foreign sourcing for interest paid by foreign branches of U.S. banks on bank deposits) could be applied to avoid the imposition of any applicable CBIT on such interest paid to a foreign lender. This approach would raise numerous technical and compliance issues. For similar reasons, borrowing through a foreign subsidiary would not be advantageous if borrowed funds were to be used in the United States.

38. Alternatively, the credit could be fully refundable, without regard to the taxpayer's other tax liability. Making the credit nonrefundable is, however, consistent with the decision in Chapters 3 and 11 not to permit refunds of excess imputation credits to low-bracket shareholders and with the treatment of tax-exempt and foreign investors described in the text below. Although interest and dividend income would not be taxable under CBIT, most low-bracket individuals who would invest in CBIT entities should have sufficient tax liability on wages and nonCBIT income to use the CBIT investor credit.

39. See also American Law Institute, Reporter's Memorandum No. 3 (1991).

40. See Chapter 6. Under a distribution-related integration system that denies refunds of imputation credits on corporate dividends, tax-exempt investors would have an incentive to invest in debt rather than equity. By imposing a tax on investment income, the taxation of debt and equity would be conformed, and tax-exempt entities would have an incentive to invest in dividend-paying stock to use the excess imputation credits against the tax due on other income. This structure would

encourage tax-exempt entities to hold a mixture of debt and equity, since the excess credits associated with corporate dividends could be used to offset the tax due on other kinds of investment income.

41. In theory, the policies which led Congress to enact IRC § 263A(f) would justify its retention for small business entities; however, given the capitalization threshold for application of IRC § 263A(f)(1)(B) (assets costing more than $1 million or having long life or production period), retention of its complexity may not be justified for the few situations in which it would apply. In contrast, absent special rules to equate self-constructed and purchased assets, capitalization of interest for CBIT entities could undercut the CBIT revenue base by converting some nondeductible interest into basis eligible for cost recovery.

42. The rules of IRC § 265 would, however, be expanded to limit the deduction of expenses attributable to CBIT interest and dividend income. See Section 4.I.

43. A similar expansion of IRC § 265(a)(4) to cover regulated investment companies and other conduits which hold stock and debt of CBIT entities also will be required. See Section 4.H.

44. If A's lender were taxable, the disallowance of interest deductions to A would result in the collection of a double tax. However, the potential for tax arbitrage described in the text led us to adopt the disallowance solution.

45. As discussed in Section 4.E, the prototype computes the foreign tax credit limitation by calculating a branch's foreign source income taking into account the interest deduction allowed to the branch under foreign law. The alternative is to require allocation and apportionment of interest expense to the foreign source income as under current law. In that case, the provisions listed in the text would continue to be relevant for purposes of determining the foreign tax credit limitation.

46. For example, if the seller enjoys a reduced rate on capital gains, compared to a zero rate on CBIT interest, this tension will be reduced, but not eliminated. See also Chapter 8.

47. The Service's guidelines for ruling that a lessor is the owner of assets for tax purposes (and hence that the lessee's payments are rents) include rules governing (1) the length of the lease compared to the useful life of the property, (2) the residual value of the property at the end of the lease, (3) options to purchase or sell property at the end of the lease term, and (4) the lessor's equity investment in the property. See Rev. Proc. 75-21, 1975-1 C.B. 715. See also Rev. Proc. 75-28, 1975-1 C.B. 752, Rev. Proc. 76-30, 1976-2 C.B. 647, and Rev. Proc. 79-48, 1979-2 C.B. 529.

In theory, every leasing transaction has an interest component, because the lessee obtains current performance (the possession of the property) but makes deferred payments. In that sense, a lease is economically similar to an installment sale of the property. Compare Halperin (1986) (several different types of accelerated or deferred payments contain implicit loans); Mundstock (1991) (economic equivalence of loans and leases). The degree of similarity between the two, however, depends on several factors, including the term of the lease agreement and the rights retained by the lessor with respect to the property. The tax law historically has respected a broad range of leases, and we do not think it necessary to change that treatment in the move to CBIT, although it would be possible to consider CBIT treatment for certain rents and royalties.

48. That the courts' efforts in this area have led to inconsistent results is hardly surprising given the factual nature of each inquiry into who is the true owner of property that is the subject of complex contractual arrangements between parties. No case shows this inconsistency better than the Supreme Court's only examination of this area in the last 50 years, *Frank Lyon* v. *United States*, 435 U.S. 561 (1978), rev'g 536 F.2d 746 (8th Cir. 1976), rev'g 75-2 USTC ¶ 9545 (E.D. Ark. 1975). Based on all of the facts and circumstances, the trial court upheld the taxpayer's contention that it was the true owner of the building. The Court of Appeals, however, analogizing the rights of a property owner to a bundle of sticks, agreed with the government's argument that taxpayer "totes an empty bundle and that the term 'owner' for tax purposes cannot reasonably be attached to the empty wrapping taxpayer has retained." 536 F.2d at 751. The Supreme Court then undertook its own evaluation of the facts, and cited some two dozen facts to support its conclusion that the taxpayer was the tax owner of the building. Statutory standards might help the courts to reach more consistent results.

49. See IRC §§ 483, 1274. IRC §7872 also should be retained in order to characterize properly the interest component of certain below-market loans.

50. It may be possible to simplify the current OID rules for CBIT debt, because neither the issuer nor the lender must currently accrue deductions or income. Thus, it may be sufficient to adopt rules that correctly identify the character of payments. Compare IRC § 483. Similar rules may be needed to distinguish dividend payments from redemption payments on preferred stock. See § 305(c). The treatment of capital gains under CBIT may, however, result in some retention of the current timing rules. If capital gains on CBIT debt are taxed, it may be appropriate to provide debtholders with an increase

in basis (with a corresponding debit to the issuer's EDA) to ensure that accrued discount on CBIT debt is not taxed as capital gains when the debt is sold. See Section 9.B.

51. Consideration might be given to providing Treasury with the option of issuing both taxable debt and tax-exempt debt.

52. See IRC § 103.

53. The exemption also may permit distributions to be taxed at a lower rate, if the beneficiary is in a lower tax bracket after retirement.

54. "CBIT income" refers to dividends and interest on CBIT debt and equity (and, if capital gains on CBIT debt and equity are exempt from tax under CBIT, capital gains on such assets). The two accounts would increase when the pension fund receives contributions, nonCBIT income, or CBIT income, and would decrease when the pension fund makes distributions to beneficiaries. If CBIT income were reinvested in nonCBIT assets, only the return on those assets would be added to the nonCBIT income account. If no compensatory tax is adopted, CBIT income would include only excludable CBIT interest and dividends.

Pension funds would, as under current law, also track nondeductible employee contributions, which are exempt from tax when distributed.

The transition to the new regime should be straightforward. Pension funds would calculate the sum of all previous contributions and investment earnings on the date of enactment of CBIT. Those earnings would go into the nonCBIT account, and any future CBIT earnings would go into the CBIT account.

55. Special rules may be needed to limit the allocation of EDA balances to preferred stock upon liquidation. For example, it may be inappropriate to allocate any EDA to preferred stock on which current, fully excludable dividends have been paid. In that case, the liquidation proceeds simply represent a return of capital.

56. IRC § 732 prevents a step-up in basis, however, thereby preserving a potential tax whenever the distributee partner disposes of the distributed asset.

57. Such exceptions might be patterned on existing IRC §§ 731-732 or prior IRC § 333, which was repealed in 1986.

58. See Treas. Reg. § 301.7701-2. In general, an organization that has associates and an objective to carry on business for joint profit is classified as a corporation rather than a partnership if it has more corporate characteristics than noncorporate characteristics. The corporate characteristics relevant to this determination are (1) continuity of life, (2) centralization of management, (3) limited liability for debts, and (4) free transferability of interests.

59. IRC § 7704.

60. IRC § 851 et seq. A RIC also may retain and pay tax on long-term capital gains, in which case shareholders must include such gains in their income and are credited with their share of corporate tax paid.

61. IRC § 856 et seq. REITs are allowed a dividends-paid deduction for distributions of both ordinary income and capital gains income, but are not allowed to impute retained capital gain income to shareholders.

62. IRC § 860A et seq.

63. See IRC § 1381 et seq. which generally apply to cooperatives. See also IRC § 501(c)(12) (certain cooperative telephone or electric companies); and IRC § 521 (farmers' cooperatives).

64. These changes also would apply to sole proprietorships not eligible for the small business exception.

65. IRC § 265(a)(4) should be expanded to cover CBIT investments of all three conduit entities. As discussed in the context of rules for savings and loan associations under CBIT, policymakers could consider imposing a withholding tax of 31 percent on distributions from RICs, REITs, and particularly REMICs to tax-exempt investors attributable to home mortgage interest to prevent unfair competition between these entities and savings and loan associations.

66. The patronage dividend mechanism is sufficiently flexible that it should permit the cooperative to shift income attributable

to the disallowance of interest deductions to patrons. In effect, the cooperative could substitute a patronage deduction for the interest deduction if patrons are generally in a tax bracket under 31 percent.

67. For example, consideration might be given to allowing banks to pay deductible (and includable) interest on a limited class of deposits. The possibility of such an option for savings and loan associations is discussed in the text below.

68. Unlike the alternative approach, this rule would require a provision defining the institutions eligible for its special rule; e.g., the special rule could apply to CBIT entities that earn at least 80 percent of their total income from interest and dividends.

69. The potential problems could be exacerbated if losses arising from nonapplication of IRC § 265(a) to financial institution operating expenses were allowed to generate net operating losses that could be used by other members of a consolidated group.

70. S&Ls may well argue that such a provision is necessary to preserve parity with REMICs and other entities which we recommend retain their conduit status. Since REMICs, for example, could market mortgage pass through instruments to tax-exempt institutions without imposition of an entity level tax of 31 percent, REMICs would clearly have an advantage in raising funds from the tax-exempt sector over S&Ls. As suggested earlier, an alternative solution to this result might be to impose a 31 percent withholding tax on REMIC distributions to tax-exempt organizations or impose such a tax directly on tax-exempt organizations receiving tax-exempt interest through a REMIC by treating such income as unrelated business taxable income. Under current law, interest paid on REMIC regular interests is tax free to tax-exempt investors and, in general, to foreign investors. A portion of the income on REMIC residual interests is subject to UBIT in the hands of tax-exempt organizations and is subject to 30 percent withholding tax when distributions are made to foreigners.

71. Under current law, insurance companies generally include in gross income premiums and investment income and deduct from gross income general business expenses and distributions to policyholders and beneficiaries. In addition, the companies are allowed to deduct the net increase in the amount of insurance reserves during the taxable year. If reserves decrease, the amount of the decrease is included in income. Over the life of any insurance policy, the net deduction for reserves is always zero (since the reduction in reserves as claims or benefits are paid generates items of income that offset the earlier deductions). Thus, the reserve deduction affects the timing of insurance company deductions for claims and benefits, but does not increase the ultimate deductions to more than the amount of claims and benefits actually paid.

Tax reserves are calculated on a discounted basis to reflect the time value of money. The deduction for the net increase in insurance reserves serves two purposes. First, it prevents that portion of premiums needed to fund future casualty or benefit payments from being taxed. Second, it provides for a deduction equal to the expected investment return on reserve funds. As a result of the combined deduction for reserves, claims and benefits, insurance companies are able to deduct currently the present value of anticipated future payments, instead of deducting those payments when made. The difference between the present value of future payments and nominal amount of those payments decreases over time, and each year a deduction is allowed to the extent of the decrease during the taxable year.

Insurance companies also make dividend payments to policyholders. Policyholder dividends consist of various components, one of which is an interest component. Dividends paid to policyholders are generally deductible from income and, among other things, provide a mechanism for life insurance companies to adjust effectively the amount of the reserve deduction for changes in the rate of investment return. Thus, the interest-like deduction available to insurance companies under current law is spread among deductions for the change in reserves, for claims and benefits paid, and for policyholder dividends paid. For a more complete discussion of the issues related to insurance company policyholder dividends, see U.S. Department of the Treasury, Report to the Congress on Life Insurance Company Taxation (1989) and U.S. Department of the Treasury, Report to Congress on Property and Casualty Insurance Taxation (1991).

72. CBIT would not alter current law rules which result in exclusion of much of the amount paid to policyholders in the form of claims, benefits, or policy dividends. Under current law, virtually all death benefit distributions payable under life insurance policies are fully excluded from gross income. Casualty claim payments are typically offset by loss (IRC § 165) or rollover (IRC § 1033) deductions allowed to the recipient. However, some other insurance company distributions are included in income. Business policyholders of casualty policies must generally include policyholder dividends in income, because they generally may deduct the related premiums. Individuals receiving policyholder dividends from either P&C or life policies or receiving policy surrender distributions from life policies generally are required to take those distributions into income only to the extent that they exceed the total of previous premium payments less previous distributions. As a result of these rules, very little of the investment income earned on cash value is included in taxable income at the individual level under current law.

PART III

Introduction

1. Under these conditions, any system of integration would result in the imposition of a single level of tax at a single tax rate, regardless of whether corporate earnings were distributed or retained. For example, assume that a corporation earns $100, and all corporate and individual income is taxed at a flat rate of 34 percent. Under the shareholder allocation prototype, $100 of income would be imputed to the shareholder, who would pay $34 in tax. The tax due also would be $34 under any of the three distribution-related integration systems. In each system, the corporation would pay $34 of tax. Under the dividend exclusion prototype the corporation could distribute its $66 of after-tax earnings tax-free to shareholders. Under the imputation credit system discussed in Chapter 11, when earnings were distributed, the shareholder would have a $34 credit, which would exactly offset his tax liability. In a dividend deduction system, the corporation would have a $100 deduction that would offset its tax liability in the year of distribution, and the shareholder would pay tax of $34. Under CBIT, the earnings would be subject to $34 of tax at the corporate level but would not be taxable upon distribution as interest or dividends to investors.

2. The equivalency analysis set forth in the preceding note does not take into account the possible additional burden created by taxing capital gains on corporate stock. See Chapter 8. Appendix C discusses the equivalence of distribution-related integration systems.

Chapter 5

1. Although no agreement exists on the precise specification of the standard accounting rules, there is sufficient conformity that most analysts are able to ascribe to an accepted list of preferential items. See, e.g., Budget of the United States Government, Fiscal Year 1992, Ch. XI, "Tax Expenditures."

2. See IRC § 312. Because corporate shareholders generally claim a dividends received deduction for both regular tax (IRC § 243) and minimum tax (IRC § 56(g)(4)(c)(ii)) purposes, preference income flows through to most corporate shareholders under current law.

3. See McLure (1979), pp. 131-32, and Polito (1989), pp. 1036-37 (both arguing that corporate preferences should be passed through to shareholders under a fully integrated tax system); and Kitchen (1987), p. 360 (defending the ability to pass preferences through under Canada's integrated tax system).

4. Congress has at times indicated a willingness to discriminate between corporate and noncorporate preferences. For example, IRC § 291 restricts the availability to corporations of certain preferences that are otherwise available to both corporate and noncorporate entities alike. See also IRC § 56(b), which specifies several AMT adjustments that apply only to taxpayers other than corporations, and IRC § 56(c) and (g), which specify adjustments that apply only to corporations.

5. See, e.g., the tax expenditure estimates presented in the Budget of the U.S. Government, cited in note 1. Although the approximately $50 billion annual corporate tax expenditures noted in the 1992 Budget overstates the magnitude of revenue cost (primarily because behavioral adjustments are not considered in the tax expenditure estimates) this figure serves to illustrate the significant revenue impact that would result from extending preferences to shareholders.

6. As discussed in Chapter 13, a complete analysis of the economic effects of the integration prototypes should include an examination of the efficiency cost of the revenue offsets.

7. See Avi-Yonah (1990), pp. 199-202.

8. See Section 2.B. The same is true of an imputation credit system of distribution-related integration. Under such a system, extending preferences to shareholders can result in shareholders receiving tax credits that exceed the corporate level taxes paid. This occurs if the integration rules implicitly (and incorrectly) assume that the corporation has paid taxes on preference-related income, and if the corporation tax rate exceeds the individual tax rate. For example, such errors would occur if a shareholder imputation credit method required that a shareholder compute his credit as a fixed percentage of dividends received (if the percentage is based on the statutory rate of tax), gross up the dividend by the amount of the credit, apply his tax rate to the grossed-up dividend, and apply the credit to the resulting tax liability. This procedure would extend preferences to shareholders whenever the corporate and personal tax rates are equal, but it would provide greater subsidy for preferences if the corporate tax rate exceeds the shareholder tax rate.

9. If it were desired to extend some (but not all) preferences to shareholders, a distribution-related integration system could be structured to accomplish this result. Preferences in the form of tax credits could be passed through simply by treating such credits the same as taxes actually paid. The relative ease of passing such credits through in an integrated system should encourage policymakers so to structure any tax preferences that it desired to pass through to shareholders. Exemption preferences also could be passed through, but, in an imputation credit system, that would require additional accounts at the corporate level and separate treatment at the shareholder level. Deferral preferences create the most substantial mechanical problems if passed through to shareholders. See also Section 3.E.

10. A compensatory tax ensures that full corporate level tax has been paid on distributed income by assessing a "toll charge" on the corporation with respect to each distribution of preference income. Section 11.B and Appendix C examine different types of compensatory tax systems. To determine the amount of the toll charge, corporations would maintain an account of corporate tax paid or of fully-taxed income to determine the amounts of fully-taxed and of preference income. A "stacking" rule could then be applied to determine the extent to which distributed earnings were made from the corporation's fully-taxed or preference income. The stacking rule most favorable to taxpayers is to treat corporate distributions as paid first from fully-taxed income and then from preference income. Thus, if the corporation has sufficient fully-taxed income to apply to distributions, the corporation and its shareholders will suffer no adverse consequences from a decision not to extend preferences to shareholders. Chapter 11 contains a discussion of stacking alternatives and their economic effects. The principal alternative is a pro rata stacking rule, which would treat distributions as containing a proportionate share of the corporation's retained preference income.

If the compensatory tax rate is set equal to the corporate tax rate, the effect is to recapture corporate tax preferences. In that case, if a corporation distributes only fully-taxed income (determined under stacking rules), no additional tax liability results. For distributions in excess of fully-taxed income, each dollar of tax-exempt preference income is subject to the full corporate tax rate, and the full amount of tax paid is available as a shareholder credit. If the shareholder credit is fully refundable, the tax system collects no additional net taxes from a compensatory tax. If the credit is not fully refundable, then the tax system collects an additional tax on preferences distributed to shareholders who have insufficient tax liability to absorb the credit or who are tax-exempt.

If the compensatory tax is set at a rate below the corporate tax rate, distributions in excess of fully-taxed income result in additional corporate level tax liability on preference income, but at less than a dollar-for-dollar rate. This achieves a result somewhat analogous to the current alternative minimum tax, because distributed preference income bears tax at a rate lower than the corporate tax rate. Setting the compensatory tax at a rate lower than the corporate tax rate differs from an alternative minimum tax: the compensatory tax is triggered only on distributions, while the current alternative minimum tax applies regardless of whether funds are retained or distributed.

A third alternative sets the compensatory tax rate equal to the shareholder rate rather than the corporate rate. This approach, adopted in the U.K. imputation system, effectively taxes the corporation at the shareholder rate on distributed preference income and allows shareholders a credit at the same rate. For shareholders who pay tax at that shareholder rate, the compensatory tax acts as a withholding tax on funds distributed to shareholders. If the shareholder credit is not refundable and cannot be carried forward, the compensatory tax creates an additional tax burden on distributed preference income for shareholders whose tax rate is less than the statutory rate. Only refundability of tax credits will eliminate such consequences for tax-exempt shareholders.

Section 11.B examines the treatment of preference income distributed to tax-exempt shareholders under both a compensatory tax and a credit limitation approach.

11. See Section 11.B for a discussion of the different methods for limiting the shareholder credit to corporate level tax actually paid. This method requires the corporation to maintain an account of corporate taxes paid. In a dividend exclusion system, the amount of taxes paid is converted into a corresponding amount of fully-taxed income. The account would be increased by corporate tax paid and the amount of credits from dividends received from other corporations and decreased by the amount of credits attached to distributions made to shareholders (or the fully-taxed income equivalents). As with the compensatory tax, a stacking rule is necessary to determine the extent to which distributions are made out of fully-taxed income. Shareholder credits with respect to distributions would thus be allowed only to the extent the corporation's account was sufficient to fund the credits. Distributions considered made out of preference income would not carry imputation credits and, thus, would be subject to tax at the shareholder tax rate, as under present law.

12. See Section 11.B.

13. See Section 2.B. If integration were extended to retained earnings through a dividend reinvestment mechanism, a decision not to extend corporate level tax preferences to shareholders could readily be implemented by restricting the dividend

reinvestment option to fully-taxed retained earnings. This could be accomplished by limiting the dividend reinvestment option to the balance in the corporation's EDA, in the dividend exclusion and CBIT prototypes, or the SCA, in the imputation credit prototype. See Chapter 9.

14. See Section 4.D.

15. See Section 3.E.

Chapter 6

1. In some cases, the Code also permits deductibility of donors' contributions as charitable contributions (IRC § 170), while contributions to pension funds are generally deductible as business expenses (IRC § 404).

2. This is true only when individuals' tax rates are constant over their working life and in retirement. If tax rates during retirement are lower, current law treatment of pension savings is even more valuable.

3. Income from an exempt organization's investments in a publicly traded partnership is subject to UBIT, regardless of whether the partnership's business is unrelated to the entity's exempt purpose.

4. As Chapter 5 notes, most preference items confer tax deferral rather than complete exemption. Corporate income sheltered from tax by a deferral preference can be distributed to a tax-exempt shareholder without shareholder level tax, preserving the value of tax deferral until the preference "turns around" and additional tax is imposed at the corporate level. Corporate preference income distributed as interest to tax-exempt debtholders receives even more favorable treatment: not only is the income exempt from tax at both the corporate and shareholder level, but the interest deduction may be available to offset otherwise taxable income. This benefit is not available for all preference income. IRC § 265, for example, disallows deductions for interest and other expenses attributable to tax-exempt bond interest.

5. In 1989, tax-exempt entities were allocated $1.6 billion in income from partnerships, or approximately 2 percent of the total amount allocable to all partners. Of the tax-exempts' share, an estimated $260 million was trade or business income that could have been subject to UBIT. The remainder consisted of rents, royalties, interest, dividends, and other forms of income not subject to UBIT.

6. Depending on the integration system adopted, there could still be an advantage in distributing corporate preference income to tax-exempt shareholders. For example, under a shareholder credit limitation system, preference income would be exempt from tax at the corporate level and would be exempt from tax at the investor level if distributed to a tax-exempt shareholder. Retained preference income, realized in the form of capital gains on stock, also would be exempt from tax in the hands of a tax-exempt shareholder. A compensatory tax, discussed in Section 11.B, would impose a corporate level tax on distributed preference income, but would not change the treatment of retained preference income.

7. A dividend exclusion system would not provide equivalent treatment of debt and equity held by tax-exempt investors unless interest also were nondeductible at the corporate level and excludable by the recipient. This regime is CBIT; see Chapter 4.

8. See Sections 11.E and 12.A, respectively. A dividend deduction system without withholding would equalize the treatment of debt and equity investments by tax-exempt investors. Corporations would be able to deduct dividends paid, as they now deduct interest, and neither type of income would be taxable to the tax-exempt investor. This result could be changed by denying the deduction (or the benefit of the zero rate) for dividends paid to such tax-exempt shareholders, but such an approach would require corporations to track the identities and tax status of shareholders. Coupling a nonrefundable "withholding" tax with a dividend deduction could achieve results similar to a nonrefundable credit under an imputation credit method of integration.

9. The United Kingdom refunds the imputation credit to tax-exempt investors. However, while the U.K.'s imputation credit is fully refundable to all domestic shareholders, including tax-exempt shareholders, the U.K. has a partial distribution-related integration system, so earnings distributed to a tax-exempt shareholder still bear a tax equal to the excess of the corporate rate over the credit rate. See Appendix B. Tax-exempt organizations own approximately 40 percent of the outstanding stock of U.K. companies.

10. An effort to provide tax-free treatment for corporate income allocated to tax-exempt or tax-favored investors under CBIT would raise major problems. For income distributed in the form of interest and dividends, the relative advantage of such investors could be maintained by providing refunds of corporate tax paid with respect to funds distributed. For undistributed

income, however, eliminating the corporate level tax would require allocating undistributed income to the shareholders—exactly the type of administrative complexity that occurs under a shareholder allocation system and that the CBIT approach to integration seeks to avoid.

11. A dividend deduction proposal passed by the House of Representatives in 1985 would have made a portion of dividends received by certain tax-exempt organizations subject to UBIT. See H.R. 3838, 99th Cong., 1st Session, § 311 (1985) and H. Rept. No. 426, 99th Cong., 1st Sess. (1985), p.240.

12. For example, under an imputation credit system of distribution-related integration, providing full shareholder imputation credits on dividend income to tax-exempt investors would allow them to invest in a mix of equity and debt so the credits could be used to offset the tax on other investment income. This approach is similar to Australia's system for tax-exempt investors, adopted shortly after enactment of a shareholder credit limitation integration system. Allowing the credit to offset other investment income also discourages streaming of franked dividends to taxable investors and unfranked dividends to tax-exempt investors.

For example, assume a tax-exempt entity earns $100, of which $25 is dividend income and $75 is interest income. Assume, in addition, that the dividend carries an imputation credit for corporate tax paid at a 31 percent rate and that the tax-exempt entity is subject to tax on all investment income at a 12 percent rate. The net dividend of $25 would be treated as a gross dividend of $36.23, with a tax credit of $11.23. The tax-exempt entity would have a tax liability (before credits) of $13.35 ($.12 \times 111.23$), which would be offset in part by the $11.23 credit. The net tax due would be $2.12.

13. If credits are nonrefundable, the revenue neutral rates are as follows: 8.4 percent for shareholder allocation, 7.6 percent for the imputation credit prototype, 7.2 percent for CBIT with no taxation of capital gains, and 6.1 percent for CBIT with current law capital gains taxation.

Chapter 7

1. Unlike many other countries, the United States also taxes the worldwide income of all U.S. citizens and U.S. corporations, whether or not they are residents of the United States.

2. Some or all of the U.S. shareholders of a foreign corporation may, however, be subject to current U.S. tax on all or a portion of the corporation's income if it earns income which is either passive, e.g., interest, dividends, royalties, and similar income or particularly mobile or holds assets that produce such income. See, e.g., IRC §§ 951, 1293.

3. Thus, for example, if a foreign subsidiary of a U.S. company earns $100 abroad, pays $40 in foreign corporate level taxes, and remits $27 in dividends to its U.S. parent ($30, net of a $3 withholding tax imposed by the foreign country), the parent must report $50 in foreign source dividend income ($27 plus $3 plus 50 percent of $40), and can claim a credit (subject to the appropriate limitations) for direct foreign taxes of $3 and indirect foreign taxes of $20.

4. Merely acquiring U.S. stock and debt securities does not constitute a U.S. trade or business.

5. See, e.g., Bergsten, Horst, and Moran (1978) and Caves (1983). In the public economics literature, studies by Musgrave (1969), Horst (1980), and Giovannini (1989) have attempted to compare the relative efficiency of capital export and capital import neutrality under various stylized assumptions. See also the overview in JCS-6-91 (1991).

6. See "Savings and Investment" in Section 1.B.

7. Setting tax rates independently implies that countries take policies of their trading partners as given, and misestimate effects of their own policies. See, e.g., Gordon (1983). In particular, analyses of capital export neutrality often assume that foreign countries' tax rates are independent of the resident country's tax rates. The source country may, of course, take into account that most investment from abroad originates from countries that grant a worldwide credit for foreign taxes paid. The source country may, therefore, be able to increase taxes on foreign investment without reducing capital inflows because foreign governments, not investors, would absorb the tax. In effect, a policy of capital export neutrality may lead to a transfer from the resident country's treasury to that of the source country.

8. The foreign tax credit tends to promote capital export neutrality, because it eliminates an investor's U.S. tax liability to the extent of foreign taxes paid, but requires the investor to pay a residual U.S. tax if the U.S. tax rate is higher than the foreign tax rate. In this situation, the investor is neutral between domestic and foreign investment, because the investor bears

the same tax burden in either case. For additional discussion, see Hines and Hubbard (1990) and JCS-6-91 (1991). As explained in the text, however, the foreign tax credit does not always have this effect.

9. The indirect credit thus provides equal treatment for foreign direct investment by U.S. corporations, whether through a foreign subsidiary or a foreign branch operation.

10. This conclusion turns on accepting, as we do in Chapter 13, the traditional view of dividends. See Section 13.B. For additional discussion of these issues, see Hines and Hubbard (1990) and the studies cited therein.

11. The statutory exemption for portfolio interest reflects the difficulty of taxing highly mobile debt capital. The exemption for capital gains represents an incentive to foreign persons to invest in U.S. capital markets and a concession to the administrative difficulties of determining gain and collecting tax where the income is not physically paid from U.S. sources.

12. Treaties also suggest another explanation for the nondiscrimination rule—to protect the bargain agreed to by the parties. Treaties limit withholding rates but generally do not impose direct limitations on a source country's right to tax business profits. This creates some risk that the source country may alter the bargain, without directly affecting withholding rates, by changing the way that business profits are taxed to foreign investors. The nondiscrimination rule indirectly prevents this by requiring that changes in the taxation of business profits burden domestic and foreign capital equally.

13. The shareholder allocation prototype treats foreign taxes by statute like U.S. taxes, but we do not recommend adoption of that prototype.

14. The following examples illustrate the tension between a policy of avoiding additional taxation of foreign source profits and a policy of collecting one level of U.S. tax on profits from all sources. Assume that a U.S. individual owns 100 percent of a domestic corporation that in turns owns 100 percent of a foreign corporation. The U.S. corporate rate is 34 percent, the individual rate is 31 percent, and the United States has adopted a dividend exclusion system. The foreign corporation earns $100 of foreign profits in the relevant taxable year and pays foreign taxes of $25. The foreign subsidiary later distributes the after-tax income to its domestic parent, which distributes the dividend (net of any U.S. tax) to its sole individual shareholder. If the domestic parent is required to include $100 of profits in income for the taxable year of the distribution but is given a tax credit of $25 against its U.S. tax liability, and the individual is allowed to exclude the dividend altogether, then the aggregate level of tax of the foreign profits will be no greater than if the profits were from domestic sources. No additional taxation will exist. Compared to current law, exempting the dividend in the hands of the individual shareholder will significantly reduce the United States' portion of the aggregate tax burden borne by the foreign profits. The United States' portion of the total tax paid will only be $9 out of $34, or 26 percent of the total, compared to the United States' portion under current law: $29 out of $54, or 54 percent of the total.

If, in contrast, the tax regime provides a credit for the $25 of foreign taxes paid by the subsidiary to the domestic parent but requires the individual shareholder to pay tax upon the appropriate portion of the subsequent distribution by the parent under the dividend exclusion prototype, then the foreign profits will bear an additional amount of tax relative to a similar amount of domestic profits. The domestic corporation will owe $9 of additional tax upon receipt of the distribution from the foreign shareholder, and the individual shareholder will owe a tax of $15 upon the subsequent distribution of a grossed-up dividend of $49. The foreign profits will have been subject to aggregate foreign and U.S. taxation of $49, in comparison with aggregate taxation of $34 for similar profits from domestic sources. Under this approach, the United States' portion of the total taxes paid for such income will be $24 out of $49, or 49 percent of the total. However, the total tax burden on the earnings decreases to $49 from current law's $54, because there is only one level of U.S. residual tax.

15. This problem would be even more severe if shareholder credits in a shareholder allocation or imputation credit system were actually refundable, rather than simply available to offset tax liability on other income.

16. See Sections 2.C and 11.D.

17. See Section 4.D.

18. See Section 3.J.

19. For domestic corporations owned by foreign shareholders, the first level of tax is the normal domestic corporate tax and the second level is the 30 percent withholding tax on dividends. For a U.S. branch of a foreign corporation, the first level is the corporate tax on the branch's U.S. business income and the second level is the branch profits tax under IRC § 884(a).

20. Other countries with integrated tax systems, as a rule, have not extended benefits of integration to U.S. shareholders except as a result of tax treaties. However, the U.S. treaties with the U.K., Germany, and France extend some benefits of integration to U.S. shareholders in certain cases. On the other hand, Australia generally extends the benefits of integration to foreign shareholders by statute. See Appendix B.

21. The following example illustrates the problem in the context of an imputation credit system that refunds imputation credits to foreign shareholders. The issues would be the same in a dividend exclusion system that refunded corporate tax to foreign shareholders. Assume, for example, that two domestic corporations each earn an annual pre-tax profit of $100. Corporation A has one shareholder, a U.S. resident individual. Corporation B also has one shareholder, a nonresident alien individual who resides in a country that has a tax treaty with the United States. The tax treaty limits the U.S. dividend withholding rate to 15 percent for portfolio investors (including the shareholder of corporation B) and contains a standard prohibition against discrimination based on capital ownership. Assume also a 34 percent corporate tax rate, a 31 percent individual tax rate and that corporate taxes are credited to shareholders at the 31 percent individual rate.

If neither corporation distributes earnings, each pays a tax of $34 on its $100 profit. No discrimination exists between the two corporations, and the withholding rules are not implicated. If, instead, each corporation distributes one-half of profits, the domestic shareholder receives a cash distribution of $33, an imputation credit of $14.83, and a grossed-up dividend, i.e., including credit of $47.83. See Section 11.B. The domestic shareholder will have a tax liability with respect to the gross distribution of $14.83, which will be exactly offset by the imputation credit. Thus, for corporation A both distributed and retained earnings are taxed at a 34 percent rate.

There is a significantly different result for corporation B. The foreign shareholder receives a cash dividend of $33. If he also receives an imputation credit of $14.83, his gross dividend will be $47.83. The withholding tax on this distribution will be $7.17, entitling him to a refund of $7.66. In this case, undistributed profits are taxed at 34 percent, but distributed profits are taxed at 18.7 percent ($50 of pre-tax income that bears $17−$7.66 of tax).

22. In the past, countries with nonintegrated tax systems, including the United States, have responded that this argument is highly stylized, that it ignores the economic reality that profits distributed to foreign shareholders bear a higher level of tax than profits distributed to domestic shareholders, and that such an integration regime is discriminatory. As noted in the text, this response has generally been rejected by countries with integrated systems, although the United States has had some success in negotiating partial integration benefits for its shareholders.

23. See Section 2.A.

24. This would not be true in an integration system that imposed both a nonrefundable compensatory tax and a withholding tax on dividends. A nonrefundable compensatory tax combined with a withholding tax would subject distributed preference income to two levels of tax, rather than the one level of tax imposed under current law. (Note that, if a compensatory tax were adopted in CBIT, the current withholding tax on dividends would be repealed.) See Section 4.E.

25. See Section 3.I.

26. See Section 6.D, which describes such an approach for tax-exempt entities. Such an approach would minimize portfolio shifts by foreign shareholders and would provide an opportunity for achieving greater parity between debt and equity investments in U.S. corporations by foreign investors.

Chapter 8

1. Presumably, if shareholders were not taxed on gains, they would not be allowed losses on stock sales.

2. As described in Section 13.B, we accept the traditional view of dividends, under which the value of $1 of retained earnings is $1 as long as the managements of corporations maximize firm value. Under the new view, also described in that section, distributions to shareholders in the form of dividends are unavoidable. For a dividend paying corporation in this view, an incremental dollar of retained earnings raises share value by less than $1.

3. The value of stock in a corporation that has retained earnings may include the value to a prospective purchaser of the resulting capital loss that will be realized when the stock is resold after the earnings are distributed, although the value of this loss to a purchaser depends on the purchaser's marginal tax rate and ability to use capital losses, and the amount of time the purchaser expects to elapse before the earnings are distributed and it dispose of the stock.

Assume, for example, that a dividend exclusion system is adopted and that the corporate and shareholder tax rates both are 34 percent. A corporation earns $100 of fully-taxed income in year one and pays $34 in tax, so it has retained earnings of $66 and an EDA balance of $66. How much should a prospective purchaser pay for all the stock? The answer is that the purchase price of the stock will vary between $66 and $100, depending on the tax attributes of the purchaser and the expected timing of the distribution of the $66 of retained earnings and the purchaser's resale of the stock.

The after-tax value of the retained earnings to any purchaser is $66. In addition, if the corporation distributes all of its earnings, the shareholder will realize a capital loss upon disposition equal to the amount paid for the stock. (The amount realized on the disposition would be zero, assuming the corporation has no assets after the distribution.) In theory, the value of the capital loss may be as great as $34 (and thus, a purchaser would be willing to pay $100) if: (1) the distribution of the earnings and the disposition of the stock are expected to occur very shortly after the purchase of the stock, (2) the purchaser expects to have sufficient capital gains against which to use the capital loss, (3) the purchaser expects to face a 34 percent marginal tax rate, and (4) the distribution does not reduce the basis of the shares.

The value of the capital loss may be much less. The value of the capital loss will be less if the shareholder does not dispose of the stock immediately, cannot use the capital loss immediately, or is subject to tax at a marginal rate of less than 34 percent. If, for example, the capital loss is worth zero, the purchaser would pay only $66 for the stock.

4. Depending on marginal tax rates, the tax system may collect as little as no tax or as much as two full levels of tax on corporate earnings. If the corporate tax rate does not exceed the individual rate, the tax system may collect virtually no tax on corporate earnings if, for example, a seller of stock is tax-exempt and a purchaser is taxable. In that case, the seller will not pay tax on capital gains attributable to fully-taxed retained earnings, but, after the earnings are distributed, the taxable purchaser can sell his stock and realize a capital loss. That loss may be valuable enough to offset tax collected on the earnings at the corporate level. On the other hand, the tax system may collect two full levels of tax if, for example, a seller of stock is taxable and a purchaser is tax-exempt. In that case, the initial shareholder's capital gain is taxed in full, but the offsetting capital loss creates no tax benefit to the purchaser. Current law in some cases limits the availability of a capital loss following a distribution. See, e.g., IRC § 1059 (basis reduction for extraordinary dividends).

5. The analysis in the text oversimplifies this issue to illustrate the general point. The analysis can be complicated if preferences are subsequently distributed or if the preference is a deferral or tax credit rather than an exclusion of income.

6. This could be accomplished by increasing inside basis in a manner similar to the treatment of electing partnerships under IRC § 754 and electing purchasers of corporate stock under IRC § 338. Applying such a rule to small acquisitions of stock (particularly where there is frequent public trading) would be administratively impossible; however, using a dividend reinvestment plan could provide some relief. See Chapter 9.

7. Halperin and Steuerle (1988) indicate that total capital gains in the economy over time are approximately equal to gains attributable to inflation plus retained earnings. Their research indicates that the real gains in value in one sector, e.g., land in the 1970s, tend to be offset by real losses in another sector, e.g., corporate stock in the 1970s. According to Halperin and Steuerle, from 1948 to 1985 the total change in economywide net worth equals the sum of (1) average net investment of 12.3 percent of net national product (NNP), (2) average inflationary gains in value of 16.1 percent of NNP, and (3) average real gains in value of -2.6 percent of NNP. See also Steuerle (1991). If total capital gains are attributable only to inflationary increase in asset values and retained earnings, the case for reduced taxation of nominal capital gains on corporate stock is much stronger.

8. See IRC §§ 705 and 1367. Treas. Reg. § 1.1502-32 provides a comprehensive set of basis adjustments for C corporations that are members of a consolidated group.

9. In cases where expected increases in future earnings that are reflected in the price of equity never materialize, an equity holder may realize a gain that never creates a corresponding amount of income to be taxed under CBIT at the entity level. In that case, however, the purchaser of the equity interest will realize a corresponding loss, and disallowing both the gain and the loss achieves a roughly accurate solution.

> Example. A purchases Corp. X stock for $100, when Corp. X is expected to earn $1,000 per year. One year later, Corp. X announces a new product line that is expected to increase its earnings to $1,500 per year. A sells his stock to B for $150. Six months later, one of Corp. X's competitors introduces a superior product. Corp. X's expected future earnings decline to $1,000 per year. B then sells his stock for $100.

Without taking into account the time value of money, the marginal tax rates of the two investors, or capital loss limitations, A's $50 gain is offset by B's $50 loss.

10. A complete exemption also may create an incentive to restructure transactions. For example, because investor level gains on a sale of stock would be exempt but entity level gains on a sale of assets would not, there would be a considerable incentive to structure acquisitions of corporations with appreciated assets as stock sales rather than asset sales. This is similar to the bias that exists under current law, under which sales of stock result in only one level of tax, while sales of assets, which typically either are preceded by a liquidating distribution of assets or followed by a liquidating distribution of sales proceeds, generally result in two levels of tax.

11. Proposals made in other contexts, e.g., a mandatory IRC § 338 election, might be considered. Current law permits certain purchasers of 80 percent or more of a corporation's stock to elect to treat a stock purchase as an asset purchase. A mandatory IRC § 338 election, adapted for CBIT, would require recognition of gain at the entity level if a certain percentage of the equity of a CBIT entity changes hands. A mandatory IRC § 338 election may be more palatable in an integrated system than under current law, because any gain realized would be subject to only one level of tax. Gain would be taxed solely at the entity level, and no additional investor level tax would be due.

Another possible approach would tax capital gains realized on the sale by a CBIT entity of its equity interest in another CBIT entity, e.g., a corporation's sale of the stock of a subsidiary. For the reasons discussed above, taxing capital gains on CBIT equity realized by a CBIT entity would tend to impose a second level of tax on earnings. Taxing entity level capital gains on CBIT equity also would create disparities between equity investments held directly by individuals and those held through other entities, e.g., affiliated groups of corporations. On the other hand, extending the exemption for capital gains on CBIT equity would multiply the potential for deferral of entity level tax. Without special rules limiting tax-free contributions of assets to subsidiaries or partnerships, CBIT entities would be able to structure some sales of assets as sales of CBIT equity.

12. Auerbach (1990) discusses alternative means of retrospective capital gains taxation that approximate accrual-equivalent capital gains taxation.

13. The text focuses on the different sources of capital gains for traditional forms of equity and debt. The sources of capital gains for hybrid instruments may reflect both equity-type and debt-type gains. For example, fixed rate, nonconvertible, cumulative preferred stock of a creditworthy company may react to interest rate changes in much the same way as debt.

14. The credit quality of debt may change because of changes in the underlying value of the firm. For example, debt issued by a manufacturing firm might rise in value because the demand for the firm's product rises unexpectedly, thereby increasing the likelihood that the firm will pay off the debt in a timely manner. In essence, the debt is more valuable because the firm has become more valuable. The rise in value represents a capital gain to the debtholder. Such a gain is analogous to the gain an equity holder would realize from the same event, and the deferral concerns are the same.

15. An unexpected fall in the market interest rate, for example, could generate a capital gain to the holder of long-term, fixed rate, noncallable debt. The value of the debt would rise until the debt's interest payments would provide a new investor with a return equal to the market interest rate.

> Example. A noncallable perpetuity is a debt instrument that never matures. If the interest rate at issuance is 10 percent, a $100 perpetuity would pay $10 of interest per year. If the market rate of interest drops unexpectedly to 5 percent, the value of the perpetuity would double to $200, so its $10 annual interest payment would represent a 5 percent rate of return on the value of the debt. If the debt holder sold the perpetuity, he would realize a capital gain equal to the $100 increase in value.

The effect of changes in interest rates is less pronounced for short-term bonds because there is a shorter period over which off-market interest payments will be received and because the present value of the prepayment of principal is a more significant component of price. For example, if the bond in the example above were scheduled to mature in one year, an unexpected drop in interest rates would cause the bond to increase in value only to $104.76 ($110/1.05), rather than to $200 as with the perpetuity. However, a change in market interest rates creates an equal and offsetting gain or loss to the borrower. A decline in the market interest rate increases the amount the borrower must pay to eliminate his debt. If the borrower repurchased the debt in the example for $200, he would recognize the loss in the form of a $100 deduction. See Treas. Reg. § 1.163-4(c). If market interest rates increased, the borrower could repurchase his debt for less than its issue price and would realize income from the cancellation of indebtedness. See Treas. Reg. § 1.61-12(c).

Interest rate changes also can affect the value of equity. For example, an increase in interest rates may decrease the value of common stock to the extent that stock price reflects the discounted present value of future cash flows on the stock because the higher interest rate also will decrease the discounted present value of future cash flows from corporate assets. An increase

in interest rates also may create an offsetting increase in the value of common stock if a corporation has outstanding low-rate noncallable debt.

16. Thus, if CBIT included a compensatory tax and gains on CBIT equity were exempt, considerations of simplicity may support exempting gains and denying losses on CBIT debt (to both borrowers and lenders) as well. Although gains and losses on debt that are attributable to changes in interest rates represent real accretions to wealth (or real reductions in wealth) to borrowers and lenders, distinguishing between gains and losses on debt arising from changes in the value of the firm and those arising from changes in interest rates would be virtually impossible. Further, a change in interest rates creates no net gain in the tax system, because the lender's gain or loss is offset by the borrower's loss or gain. To the extent that debt holders and equity holders face the same tax rate and would pursue the same realization strategy, the Treasury would collect the same tax revenue if such gains and losses were included in taxable income as it would if such gains and losses were ignored. This conclusion is weakened if differences in tax rates and differences in the timing of realization are taken into account. Excluding all gains and losses on debt could create a net loss of tax revenue to the system in some cases, e.g., if interest rates increase and the lender is tax-exempt and the borrower is taxable. Strengthening the case for exempting such gains and losses is the observation that they are most important for long-term, fixed rate debt with call restrictions. Long-term, fixed rate debt has become less important in recent years. For nonfinancial corporations, the ratio of long-term debt (corporate bonds, mortgages, and tax-exempt bond) to total credit market debt has fallen from 71.6 percent in 1962 to 56.4 percent in 1990. See Flow of Funds Accounts (1991). To the extent that even long-term debt has more flexible interest rate adjustment than in the past, long-term fixed rate debt is even less important than the above calculation would suggest.

17. See IRC § 302. A redemption also may qualify for sale treatment if it terminates a shareholder's interest in the corporation or is made to a noncorporate shareholder in a partial liquidation.

18. The analysis in the text generally applies to individual shareholders. Corporate shareholders, which are entitled to a dividends received deduction (DRD), may favor dividends over share repurchases even under current law. A corporation entitled to a 100 percent DRD would always prefer a dividend, which would be entirely tax-free and would preserve share basis to offset later gains. A corporation entitled to a 70 or 80 percent DRD might prefer dividends in some cases.

The problems raised by share repurchases under the classical system are discussed at length in the American Law Institute (1989), which recommends adopting "a minimum tax on distributions" of 28 percent (the maximum rate applicable to individual taxpayers at the time) on the gross amount of any nondividend distribution to ensure that the second level of tax is collected. See Section 12.C.

19. Thus, a shareholder with a basis of $150 in his stock would pay the same amount of tax on a $200 distribution and a $200 payment in full redemption of his stock. In each case, the $200 payment would result in $50 of capital gain.

The rules determining stock basis should be reexamined under shareholder allocation. Although each share of stock has traditionally been viewed as having a separate basis, an aggregate basis approach may be more suitable under shareholder allocation, as under the partnership rules. For example, if aggregation is not permitted and a shareholder holds both low basis shares and high basis shares, a pro rata distribution might result in recognition of gain on the low basis shares, while an equivalent amount paid in full redemption of only a portion of the stock might be tax-free because the shareholder could choose to surrender only high basis shares.

20. A DRIP would reduce the bias against share repurchases out of taxable income. DRIPs are discussed in Chapter 9.

21. Some have contended that the best approach would recharacterize a share repurchase as a pro rata dividend, followed by sales of shares among shareholders to reflect the fact that, after a share repurchase, some shareholders have cash and others have an increased proportionate interest in the corporation. All shareholders would pay tax on ordinary dividend income and would add that amount to share basis. Selling shareholders would recognize gain or loss measured by the difference between the amount realized on the sale and their basis in the shares. See Chirelstein (1969). Abandoning the realization requirement to tax nontendering shareholders would create additional complexity and administrative difficulties. Indeed, since integration reduces the tax incentives for share repurchases over dividends in comparison to current law, a change in that policy does not seem appropriate or necessary. Moreover, allocating the EDA balance among all shareholders would require income allocations as complex as those required in the shareholder allocation prototype. See Chapter 3.

22. Attempting to treat third-party sales of shares as dividends that would be excludable to the extent of the issuing corporation's EDA balance would entail information reporting (by brokers to the issuing corporations and by issuing corporations to selling shareholders and the IRS) to an unprecedented degree. Such a system would be highly impractical and undesirable.

23. Rules similar to those in IRC § 302 would be retained. Because corporations, for example, may have an incentive to use redemptions of tax-exempt shareholders' stock in a dividend exclusion system, it might become necessary to reduce EDA balances in proportion to shares redeemed.

24. Example. A corporation owns an asset worth $100 and its sole shareholder has a basis of $100 in her stock. The value of the asset declines to $60, and the shareholder sells her stock for $60, realizing a $40 capital loss. If the corporation then sells the asset for $60, it too will realize a capital loss.

A shareholder level loss that mirrors an unused net operating loss at the corporate level is similar to a shareholder level loss attributable to unrealized depreciation.

Example. The facts are the same as in the preceding example, except that the corporation sells the asset before the shareholder sells her stock. The corporation has no taxable income (and no EDA balance), so that the $40 loss represents an NOL carryforward available to offset future income. The shareholder sells her stock for $60 and realizes a $40 capital loss.

25. Under current law, capital losses of individuals are allowed only to the extent of capital gains plus $3,000 of ordinary income. See IRC § 1211(b). It would be possible to allow capital losses on corporate stock only to offset capital gains on corporate stock (plus $3,000 of ordinary income) and generally match loss and gain duplication to reduce loss duplication. See also IRC §§ 269 and 382-84; Treas. Reg. §§ 1.1502-21 and -22.

Chapter 9

1. A system of basis adjustments for retained earnings is inherent in the shareholder allocation prototype. See Chapter 3. A DRIP also may be appropriate in the imputation credit prototype described in Chapter 11. Section 11.I discusses special considerations in adopting a DRIP in the imputation credit prototype. A DRIP would be unnecessary under CBIT if gains and losses are not taxed to investors, because basis in such investments would be irrelevant.

2. This would not be true in the case of a dividend deduction system, discussed in Chapter 12. Under such a system, deemed dividends would be taxable to shareholders but would give rise to a corporate level deduction. Thus, at minimum, a DRIP in a dividend deduction system would require shareholder consent, as under current law. While we do not address the issue further, we question whether a DRIP should be allowed in a dividend deduction system. Rate arbitrage might occur if a corporation and its shareholders can elect a current corporate level deduction in return for a shareholder level tax.

3. For example, under the dividend exclusion prototype, a shareholder must meet a 45 day holding period in order to exclude dividends received. See Section 2.B.

4. For example, dividend stripping generally results in basis reduction under current law, and the same rules may be appropriate in the context of a DRIP. Basis allocation rules also might be used.

Example. The facts are the same as in Example 1, except that the fair market value of X shares at the time of the DRIP distribution is $10 per share. Under these circumstances, the basis of both Lot A and Lot B shares will exceed fair market value under either allocation method. In these circumstances, basis sufficient to bring the basis of all shares up to fair market value should be so allocated. The balance should be allocated to all shares, pro rata.

5. The EDA would continue to be available to pay excludable dividends (or interest, in CBIT) on any class of stock (or debt, in CBIT). In theory, it would be possible to maintain a separate EDA, as well as a deemed dividend account, for each class of stock. However, such an approach would require unacceptably complex allocations of the EDA among classes of stock, similar to the allocations of corporate income required under the shareholder allocation prototype. See Chapter 3.

6. We rejected three alternative rules. First, the stacking rule could treat cash distributions first as a return of capital to the extent of previous deemed dividends. The rule recommended in the text is more favorable than this rule for any corporation with a remaining EDA balance, because shareholders would generally prefer excludable dividends to basis reduction. Second, the stacking rule could follow current law and treat cash distributions as a return of capital only after a corporation's earning and profits are exhausted. Deemed dividends that had been declared would reduce earnings and profits by the amount of the deemed dividend and cash distributions would be tax free to the shareholder to the extent treated as payments out of the remaining EDA. This rule would be consistent with the current treatment of corporate dividends and with the notion that shareholders recover capital only after recovering earnings. Under this rule, however, a corporation that had used the DRIP to eliminate its EDA balance but had additional earnings and profits attributable to retained preference income would be

required to pay taxable dividends before it could treat distributions as a return of capital. While corporate shareholders entitled to a DRD might prefer taxable dividends to basis reduction, we believe that the rule in the text is more favorable to taxpayers in most cases. Finally, cash distributions might be treated entirely as dividends and no earnings and profits account or account of deemed dividends would be kept. The advantage of the third alternative is that corporations would not need to keep an account of deemed dividends. This approach, however, may discourage use of DRIPs.

7. We would not permit DRIPs for debt in CBIT because interest is generally paid in cash as it accrues. As Section 4.G discusses, CBIT would generally retain OID or imputed interest rules to distinguish payments of interest from payments of principal. CBIT would not, however, retain the current rules governing the timing of imputed interest income.

This approach raises the question of how accrual, e.g., zero-coupon, and payment-in-kind bonds would be treated. Consideration should be given to adopting rules that would prevent accrued discount (which, like interest, is not taxable to a debtholder when received) from being taxed as capital gain if the debt instrument is sold before the discount is paid. One approach would be to maintain the current OID timing rules. Accrued discount would increase a debtholder's basis (but would not be includable in income) and would decrease the issuer's EDA (but would not be deductible). Similar issues are presented by discount preferred stock. See IRC § 305(c).

8. Mechanically, a mandatory DRIP would operate like the elective DRIP, except that a corporation would be required to reduce its EDA to zero at the end of each year through deemed or actual distributions. A mandatory DRIP might cause restrictions on the forms of equity eligible for DRIP distributions to be more desirable.

Chapter 10

1. Auerbach (1990) presents an overview of issues relating to gains and losses during the transition to integration.

2. As indicated in Chapter 13, we believe the best empirical evidence supports the traditional view of dividends, which holds that the existing two-tier corporate tax has not been fully capitalized into share values. Accordingly, we believe that integration may create some transition gains to owners of corporate stock but that such gains will not be as great as those anticipated by advocates of the new view.

3. The second and third transition concerns described in the text are sometimes referred to as carryover problems.

4. See Graetz (1977).

5. See Section 2.B and Section 4.D, respectively.

6. The stacking order rules for distributions from the EDA (see Sections 2.B and 4.D) may prolong the deferral of the tax on the retained earnings, however.

7. The American Law Institute Reporter's Study Draft (1989) on corporate tax reform contains a deduction for dividends paid that would apply only to new equity. The proposals avoid the complexity of tracking new and old equity instruments by limiting the deduction to the product of a specified rate and capital contributed after the date of enactment of the proposals, less extraordinary distributions. American Law Institute (1989). See Section 12.C.

8. The current rules governing the conversion of a C corporation, i.e., a corporation taxed under the classical system, to one of the various passthrough entities suggest the difficulties and complexities that would be involved in attempting to isolate old equity from new equity. These rules, which include the rules that apply to C corporations that convert to a partnership, an S corporation, or a RIC or REIT are concerned in varying degrees with preventing corporate income attributable to preconversion years from escaping the two-tier tax. None provides a particularly satisfying approach to dealing with the transition to an integrated corporate system.

For example, an approach modeled on the existing rules for taxing C corporations that convert to partnerships would treat the corporation as though it had distributed all its assets to its shareholders in a liquidating distribution in with built-in gain or loss with respect to the assets is realized at the corporate level and built-in gain or loss with respect to the stock is realized at the shareholder level. The shareholders would then be treated as recontributing the assets to the corporation. This mark-to-market approach would tax all the built-in gain or loss with respect to assets at the corporate level and all the built-in gain or loss with respect to stock at the investor level. (Alternatively, an approach modeled on the existing rules for taxing C corporations that convert to passthrough status as a RIC or REIT would confine the mark-to-market approach to the corporate level, with shareholders taking a carryover basis in their stock. See Notice 88-19, 1988-1 C.B. 486.) Although

the mark-to-market approach would eliminate any long-range transition effects from the change to an integrated corporate system, the substantial and immediate tax cost, together with the administrative burden that would ensue from the need to value all corporate assets, makes this approach unacceptable.

A transitional approach also could be modeled on the existing rules for taxing C corporations that convert to S corporation status. Current law does not treat the conversion as a taxable event. However, S corporation shareholders are taxable on distributions from earnings and profits accumulated in C corporation years to the extent the S corporation's distributions exceed its cumulative taxable income. IRC § 1368. In addition, IRC § 1374 provides that if the S corporation recognizes gain on an asset held at the time of the conversion within a 10 year period following the conversion, the gain is subject to a corporate level tax. The total amount of gain subject to corporate level tax cannot exceed the net built-in gain inherent in the corporation's assets at the time of the conversion. IRC § 1374(c)(2). Certain items of income and deduction that are attributable to periods before the conversion but have not yet been recognized are taken into account in computing the corporation's built-in gain. IRC § 1374(d)(5). This approach avoids the immediate tax cost associated with the partnership conversion model but does not avoid the valuation problem. It is administratively more burdensome than the partnership conversion model because the corporation has to make valuations on an asset-by-asset basis and monitor assets held at the time of the conversion (as well as income and deduction items attributable to pre-conversion periods) for a 10 year period. In addition, this approach distributes the tax burden of the transition to integration in an unequal manner because it allows those corporations with wasting assets or assets on which gain can be deferred beyond the end of the 10 year period to escape corporate level tax on the gain.

9. The choice between limiting integration to newly contributed equity and extending it to all equity reflects assumptions about the extent that investor level taxes affect corporate dividend decisions and share prices. If dividend payments are unavoidable and shareholders do not place an intrinsic value on dividends relative to retained earnings, the classical system does not create any bias against dividend distributions, and investor level taxes on dividends are already capitalized into share values. This is the new view of dividend distributions. See Section 13.B. If that view is correct, then applying integration to dividends from accumulated as well as newly contributed equity would not encourage dividends and would confer a transition gain to holders of existing equity, the price of which would increase. As discussed in Chapter 13, however, we reject the new view. Accordingly, we believe that extending integration to existing equity, particularly under a phase-in, would not confer unacceptable transition gains, and that retaining the classical system for existing equity would maintain the tax bias against dividends for such equity.

10. The Department of the Treasury recommended a phase-in approach in its 1984 proposal to provide relief from the double taxation of corporate income. That proposal generally would have allowed corporations a deduction equal to 50 percent of dividends paid to their shareholders and also would have reduced the corporate dividends received deduction from 75 percent to 50 percent. The proposed 6 year phase-in rule would have allowed a 25 percent dividends paid deduction in the first year that would have increased by 5 percentage points in each of the next 5 calendar years. Similarly, the dividends received deduction would have been 75 percent in the first year, with a 5 percentage points decrease in the deduction for each of the next five calendar years. See Treasury I, Vol. 2, pp. 136-137, 140.

11. The imputation credit prototype described in Chapter 11 could be phased in. The imputation credit prototype contemplates additions to the SCA and associated shareholder level credits by reference to the maximum tax rate applicable to shareholders, currently a 31 percent rate. Where the corporate tax rate is less than the maximum shareholder rate, it would be appropriate to base shareholder credit account and imputation credit amounts on the lower corporate tax rate. This level of integration might be phased in two alternative ways. First, a phase-in rate might be set as a percentage of the maximum shareholder rate to accomplish a smooth phase-in of integration. For example, a 5 year phase-in could base the shareholder credit account additions and allowable shareholder credits on a rate equal to 20 percent of 31 percent (6.20 percent) in the first year, 40 percent of 31 percent (12.40 percent) in the second year and so on. Alternatively, the imputation credit prototype might be phased in by linking imputation credits to a shareholder tax rate less than the maximum individual rate. For example, SCAs and imputation credits might be based on the 15 percent individual rate for a several years before moving to the 31 percent rate. If only partial distribution-related integration were contemplated, this system could be used indefinitely. Such a system would be similar to the United Kingdom's imputation system. See Appendix B.

12. See generally Graetz (1977).

13. Most corporate debt may be called without premium after a period of time, typically 5 to 7 years. Debt instruments typically permit the debt to be called earlier upon payment of a redemption premium. A CBIT phase-in is likely to significantly mitigate the increase in the cost of borrowing because corporations would be able to call their debt in substantial part before the disallowance of the interest deduction is fully phased in.

14. See Section 4.G.

15. If an accrual method taxpayer accrues but does not pay interest before the CBIT phase-in begins, then pays the previously accrued interest in a CBIT transition year, this approach assures that either holder level tax (in the form of the portion of dividends and interest includable in the income of shareholders or debtholders) or compensatory tax is paid on such interest.

16. The formula for transition years' additions to the EDA would be:

$$\text{Additions to EDA} = p\left[\frac{\text{U.S. tax paid for taxable year}}{.31} - \text{U.S. tax paid for taxable year}\right]$$

$$+ p(\text{dividends and interest received from CBIT entities}) + p(\text{allowable interest deduction})$$

where p is the transition percentage.

17. As Section 4.D discusses, payments of interest and dividends reduce the EDA in the order in which they are made. These examples assume, for purposes of illustration, that interest payments are made first and thus reduce the EDA first.

PART IV

Introduction

1. Australia, Denmark, Finland, France, Germany, Ireland, Italy, New Zealand, and the United Kingdom have all adopted imputation credit systems. See Appendix B for a discussion of certain of these countries' systems.

2. Differences among dividend exclusion, dividend deduction and imputation credit systems of integration are due to differences in tax rates applicable to different shareholders or types of income. See Appendix C.

Chapter 11

1. Individual shareholders subject to rates less than 31 percent would be allowed to use the credits against tax on other income. See Section 11.E.

2. The grossed-up dividend is the cash dividend received by the shareholder divided by one minus the maximum individual tax rate (cash dividend/1−.31).

3. Additional restrictions on the amount of the credit would be imposed to prevent streaming of credits to taxable shareholders, and consideration could be given to requiring corporations to frank dividends with credits at the full 31 percent rate as long as there is a balance in the SCA. See Section 11.F.

4. See also note 48, below.

5. A compensatory tax may take either of two forms. First, it might apply only to distributions of earnings that have not been taxed at the full corporate rate. This requires a corporation to determine the amount of corporate tax deemed to have been paid with respect to each distribution and to pay additional tax to the extent that earnings used to make the distribution have not been subject to tax at the full corporate rate. The French and German systems follow this model. See Appendix B.

Alternatively, the compensatory tax might be imposed on all distributions, regardless of the amount of corporate tax previously paid, with the compensatory tax allowed as a credit against regular corporate tax. Under such an "advance tax" system, a corporation is not required to determine explicitly the amount of tax deemed paid on a particular distribution. In an advance tax system in which the shareholder credit is computed using a corporate tax rate of 34 percent, a corporation is required to pay a compensatory tax on all dividends equal to 51.5 percent of the dividend (.34/.66). The corporation would be entitled to credit this tax against its regular corporate tax liability. Shareholders would be entitled to a credit equal to 51.5 percent of the amount of any cash distribution, and the credit would be included in income together with the cash distribution. The 51.5 percent rate applied to net cash dividends is used in lieu of applying the 34 percent corporate rate to a grossed up amount; 51.5 percent of a $66 cash dividend ($34) equals 34 percent of $100, the $66 cash dividend grossed up at the 34 percent rate ($66/.66). A corporation's ability to credit the compensatory tax against its regular corporate tax liability means that the compensatory tax results in additional tax liability only to the extent that distributions exceed the amount of fully-taxed earnings between the two regimes. The United Kingdom's Advance Corporation Tax (ACT) system represents an example of the second type of compensatory tax.

The principal substantive difference is that the advance tax system implicitly treats distributions as made first out of fully-taxed income, while a compensatory tax can, in theory, be combined with any stacking rule. In practice, most existing compensatory tax systems, such as those in France and Germany stack distributions first against fully-taxed income. While they differ mechanically, the two alternatives have similar economic impact on corporations subject to the compensatory tax.

6. If a compensatory tax is set at the corporate tax rate and is refundable to shareholders so it acts solely as a withholding tax, all distributed income is taxed only once, at shareholder rates. Although the tax is collected at the corporate level, rather than at the shareholder level, no net separate corporate level tax is imposed. The compensatory tax, however, serves to ensure payment of the shareholder level tax as preference or shielded foreign source income is distributed. The refund of imputation credits associated with distributions means that the net amount of tax borne by the distribution will be determined solely by the shareholder's tax rate and taxable or tax-exempt status.

7. Timing preferences, as well as exclusion preferences, would increase the corporate level cost of dividends in a compensatory tax system. A compensatory tax requires current payment of tax on distributed preference income, thus removing the tax deferral created by timing preferences. Consider a firm with $100 in economic income in year one and $100 worth of timing preferences. Suppose further that in year two its economic income is zero (but tax is due on the $100 deferred from the year before) and that the firm distributes all of its income in year one. With a compensatory tax, the firm has to pay $34 in year one; there is no mainstream tax to which the credit can be applied. Therefore, it carries over the $34 credit to year two, so that in year two its tax liability is zero. In contrast, under a credit limitation system, no tax is paid in year one, but $34 is paid in year two. Thus, if the firm's economic income is distributed as it is earned, the present value of timing preferences to the firm under the credit limitation scheme is greater than under the compensatory tax scheme. On the other hand, taxable shareholders would receive credits in year one in a compensatory tax regime that they would not receive in a credit limitation system. The overall effect, therefore, would depend on the relationship of the compensatory tax rate to that of the shareholders.

8. The imputation credit prototype, like the dividend exclusion prototype, is not expected to change significantly corporations' provision for income tax expense or the determination of taxes currently payable or payable at a future date for financial accounting purposes. Note 1 in Chapter 4 discusses the possible effect of a compensatory tax on corporate financial reporting.

9. Mechanically, one can determine which distributions are made out of fully-taxed income either by tracing taxable and preference income or by tracking taxes paid. A tracing-of-income approach requires the corporation to maintain different accounts for earnings and profits that have been taxed at different rates, including different accounts for income earned in different years, if tax rates have changed from year to year. We consistently recommend tracking taxes paid rather than tracing taxable income. See Section 2.B, Section 4.D, and Section 12.A. Tracking taxable income is significantly more complicated than tracking taxes paid and does not seem to offer any offsetting advantages. Australia's imputation credit system tracks taxes paid. The French and German imputation credit systems illustrate the complexity of tracking income. See Appendix B.

10. The following example compares three alternative stacking rules. The example assumes that the corporation pays tax at either 34 percent (nonpreference income) or 0 percent (preference income) and that corporate taxes paid are credited at the 31 percent shareholder rate.

Alternative Stacking Rules

	Stack Preferences Last	Stack Preferences First	Pro Rata Stacking
Economic Income	100	100	100
Preference Income	10	10	10
Taxable Income	90	90	90
Tax (@34%)	30.6	30.6	30.6
Preference Income Available for Distribution	10	10	10
Nonpreference Income Available for Distribution	59.4	59.4	59.4
Cash Distribution	50	50	50
Tax Deemed Paid on Distribution	22.46	17.97	20.22

The "stack preferences last" approach treats each dollar distributed as coming first from nonpreference income. The $50 distributed is less than the amount of nonpreference income available for distribution, thus, the distribution is deemed to be entirely nonpreference income. The "stack preferences first" approach treats each dollar distributed as coming first from preference income (taxed at zero percent) and then from nonpreference income. Thus, the first $10 distributed is deemed

to have borne no tax. The pro rata stacking approach treats each dollar as from preference and nonpreference income in the same proportion as the corporation's after-tax preference and nonpreference income. The pro rata approach thus treats each dollar distributed in the example as having borne tax at an effective rate of 30.6 percent (90/100×34%)+(10/100×0%). The indirect foreign tax credit allowed under IRC § 902 to certain U.S. corporate shareholders uses a pro rata stacking rule to determine the amount of foreign taxes associated with distributions from foreign corporations to related U.S. corporations.

11. The ACT in effect stacks distributions first against fully-taxed income. For example, assume that the corporate rate is 33 percent and the credit rate is 25 percent, and that a corporation earns $100 of fully-taxed income and $100 of preference income in a year. If the corporation distributes $100, it will pay ACT of $33.33 (.25×$100/.75). It will owe mainstream tax for the year of $33 and will be permitted to credit $25 of ACT against the mainstream tax. Thus, its tax liability for the year will be $8. The effect is the same as if the corporation had first paid $33 of mainstream tax and then paid a $133.33 grossed-up distribution, deemed to be composed of $100 of fully-taxed income and $33.33 of preference income. Compensatory tax of $8.33 (.25×$33.33) would be due on the distribution. In both cases, the total tax paid is $41.33.

In contrast, the French and German systems explicitly adopt stacking rules that stack preferences last. The German system uses an "available net equity" account to track taxable and preference income. Available net equity is divided into separate "EK" baskets, consisting of income taxed at various rates. The balances in EK 50, EK 36 and EK 0 represent income taxed at the statutory retained earnings rate, the statutory distribution rate and at a zero rate, respectively. However, the corporation's income may actually be subject to rates other than those for which corresponding EK categories exist. The German system converts each category of income subject to tax at some other rate into equivalent amounts of EK 36 and either EK 50 or EK 0, as appropriate.

The following equation converts pre-tax income subject to tax at some non-EK rate into equivalent amounts of pre-tax income subject to tax at the distribution rate (36 percent) and either the statutory rate (50 percent) or the zero rate: $.36X+(.5 \text{ or } 0)\times(Y-X) = T$, where Y equals the total amount of pre-tax income (known), X equals pre-tax income subject to the distribution rate, $(Y-X)$ equals pre-tax income subject to either the statutory rate or the zero rate, and T equals the amount of tax paid with respect to Y (known). Because X and $(Y-X)$ must be positive, the effective tax rate, T/Y, determines whether the equation must contain the statutory rate or the zero rate (and whether the residual amount of income is converted into EK 50 or EK 0). The following equations convert the pre-tax amounts, X and $(Y-X)$, into their after-tax EK amounts:

$$\text{EK 36} = (1-.36)\times X$$
$$\text{EK 50 (If T/Y} > .36) = (1-.50)\times(Y-X)$$
$$\text{EK 0 (If T/Y} < .36) = Y-X$$

French corporations are required to segregate fully-taxed income from income potentially subject to the compensatory tax or precompte mobilier for tax accounting purposes. In general, dividends eligible for the imputation credit or avoir fiscal are deemed to be distributed first out of current fully-taxed income, and then out of fully-taxed retained income of each of the immediately preceding 5 years. Once fully-taxed income for this 5 year period has been exhausted, a corporation may choose to allocate a dividend distribution to (1) dividends received from foreign subsidiaries, (2) the long-term capital gains reserve, or (3) other miscellaneous preference income, in any order. France thus allows stacking of dividends last against preference income.

Appendix B discusses these systems in more detail.

12. The formula set forth in the text is based on the formula used to determine the EDA in the dividend exclusion and CBIT prototypes. Multiplying the EDA formula by $(1/.69-1)$ converts after-tax income at the 34 percent corporate rate into imputation credits at the 31 percent maximum shareholder rate.

13. If the 34 percent corporate rate were the credit rate, the credit in the example in the text would equal $17 and the 31 percent shareholder would have an excess credit of $2.17 to offset other tax liability.

14. This is the method used, for example, by New Zealand. See Appendix B, Section B.5.

15. In general, the treatment of the adjustment as a current year item should extend only to determining the SCA balance. Interest on deficiencies or overpayments should be calculated as under present law. Under a compensatory tax, if liability is adjusted upward, the corporation would either be allowed to use accumulated excess compensatory tax to satisfy the liability or, if there is no excess, would be required to pay additional tax. If a corporation's prior year tax liability is adjusted downward, it would either increase the balance in its excess compensatory tax account, or to the extent it did not use the prior year tax liability to avoid compensatory tax on distributions, it would receive a refund. The corporation would not receive a refund of the corporate tax payment where it has been used to avoid compensatory tax because this corporate tax

payment has been claimed as a credit by shareholders. If a refund were allowed, shareholders would have been able to claim a credit for taxes that the corporation, after allowance of the refund, did not actually pay.

16. The contrary approach, which would treat audit adjustments as an adjustment to the SCA in the taxable year to which the adjustment relates, is complicated and burdensome. Under that approach, a corporation that receives a refund of corporate tax paid may have reported to shareholders credits in excess of its adjusted balance in the SCA. An unanticipated reduction would occur in the SCA for the year in question, which the corporation would have to satisfy by reducing its remaining SCA in that year, or, if there were no remaining SCA, by paying tax equal to the deficit SCA balance (together, possibly, with imposition of penalty or interest).

17. Allowing a loss to be carried back to obtain a refund of some or all of the taxes used to frank a dividend may be appropriate in theory, particularly if the corporation's shareholders are the same at the time of the dividend and the loss, but would be difficult to implement in practice. For purposes of determining shareholder level consequences, the franked dividend could be recharacterized retroactively as a return of capital or a distribution of preference income, depending upon whether the corporation had sufficient retained preferences income at the time of the dividend. If the distribution constituted a return of capital, no shareholder level tax would be due, but basis in the stock would be reduced by the amount of the distribution (which would not be grossed up for the credit). If the distribution were paid out of preference income, the amount of shareholder level tax would be computed only on the amount of the distribution (which also would not be grossed up for the credit). Requiring retroactive adjustments in shareholders' basis or tax liability would be impractical to administer, however, especially if shares of a corporation are widely held.

The argument that tax refunds should be limited to the SCA balance is weakened somewhat because, under the credit limitation system without full refundability, amounts withdrawn from the SCA to frank past dividends may not actually have been used by shareholders. Shareholders cannot obtain refunds of imputation credits, and thus tax-exempt, foreign and some low-bracket shareholders may not enjoy the benefit of some imputation credits. In contrast, in a system with full refundability of imputation credits, all SCA amounts used to frank dividends would be fully used by shareholders. While there is thus some theoretical justification for allowing refunds in excess of the SCA to the extent that the imputation credits were not fully used, it would be impractical to trace the use of the imputation credits by shareholders.

18. Current law contains limitations on the ability of taxpayers to accelerate the recognition of losses or to increase the amount of loss recognized for tax purposes to an amount exceeding the loss incurred economically. Such limitations include limitations on the deductibility of investment interest, passive activity losses, and amounts in excess of the amount the taxpayer has at risk with respect to an activity. Under present law, these limitations either do not apply to C corporations or apply only to C corporations that are personal service corporations or closely held corporations (essentially defined as corporations more than 50 percent of the stock of which is held by or for five or fewer individuals).

By eliminating or reducing substantially the tax disadvantages of incorporation, distribution-related integration may encourage the use of corporations to avoid these rules. Because distribution-related integration removes the double tax on distributed corporate earnings, taxpayers may view corporations as attractive vehicles for engaging in activities designed to accelerate or increase tax losses. For example, individuals might use passive activity losses by contributing a loss-producing passive activity and an income-producing active business to the same corporation. The deferral benefit achieved by this structure would continue until the earnings sheltered by the preference were distributed. Distributed income would be fully taxable to taxable shareholders, although it would be tax-exempt in the hands of exempt shareholders. In addition, the income generated when the preference reverses would be subject to only one level of tax. Thus, it may be appropriate to extend some of or all the loss limitation rules described above to C corporations if, after distribution-related integration is adopted, experience shows that taxpayers are using C corporations to avoid those rules.

19. A dividends received exclusion (DRE) would be as effective as a DRD in preventing multiple taxation of corporate dividends. The two could, however, produce different technical effects increases where Code limits or classifies taxpayers based on receipts or income. For example, dividends are taken into account under IRC § 448(b)(3), which limits the availability of cash method accounting for certain taxpayers with annual gross receipts in excess of $5 million. See Treas. Reg. § 1.448-1T(f)(2)(iv). By contrast, dividends are excluded under IRC § 263A(b)(2)(B), which limits capitalization of cost requirements for certain taxpayers whose annual gross receipts do not exceed $10 million. See Treas. Reg. § 1.263A-1T(d)(2)(iv)(B). Regardless of the general approach, however, special adjustments may be provided wherever appropriate. See, e.g., IRC § 170(b)(2)(B) (corporate charitable deductions are limited to 10 percent of taxable income determined without regard to the DRD). During any period of transition to integration, the current law DRD could be increased in stages from 70 percent to 100 percent as the percentage of integration increases. During periods when there is less than 100 percent integration, a 100 percent DRE would be inappropriate and also would require appropriate phase-in.

20. If all dividends were either fully unfranked or completely franked, it would be relatively easy to retain the current 70 or 80 percent DRD. The mechanics would be similar to those discussed in Section 2.B in the context of the dividend exclusion system. Partially franked dividends would create significant complexity, however. To determine its DRD a corporation eligible for only a 70 or 80 percent DRD would have to separate a partially franked dividend into a fully franked portion and a completely unfranked portion.

Example. A corporation that has a zero SCA balance owns 5 percent (by vote and value) of the stock of a second corporation and has no other assets. The second corporation pays a cash dividend of $166, which carries an imputation credit of $29.65.

The recipient corporation must convert the partially franked dividend into fully franked and unfranked components. A $29.65 imputation credit would fully frank a cash dividend of $66. Thus, the unfranked dividend is $100 ($166 − $66). After taking into account the 70 percent DRD, the corporation must pay tax of $10.20 on $30 of income.

Using the formula in Section 11.B, the corporation would add $38.55 ($29.65 for the credits received on the franked portion plus $8.90 with respect to the $10.20 of tax paid on the unfranked portion) to its SCA. If the corporation then distributed all its remaining cash to shareholders, it would distribute $155.80 of cash ($166 − $10.20) and attach an imputation credit of $38.55. Assuming a 31 percent shareholder rate, shareholders would pay tax, after claiming imputation credits, of $21.70 (($194.35 gross dividend × .31) − $38.55). This represents shareholder tax at the 31 percent rate on the remaining $70 of preference income not taxed in the hands of either corporation.

21. The alternative would tax the recipient corporation on the dividend and permit the tax to be offset by any imputation credit attached to the dividend. The imputation credit and any additional corporate taxes paid on the dividend would increase the recipient's SCA. This alternative rule would eliminate tax preferences upon the initial distribution of preference income, whether the distribution was made to a corporate or an individual shareholder.

22. A compensatory tax system might suggest a different result. Once the decision is made to tax distributed preference income to the distributing corporation, the rationale for extending preferences while the distributed income is in corporate solution may not be compelling. See Section 4.D. As noted in the text, however, some countries with compensatory tax systems (notably the United Kingdom) forgo the compensatory tax for certain intercorporate dividends.

23. See H. Rept. No. 426, 99th Cong., 1st Sess. (1985), p. 302; S. Rept. No. 313, 99th Cong., 2nd Sess. (1986), p. 515.

24. If, unlike the prototype recommended here, the SCA were based on tracing taxable income, difficulties with respect to the AMT would arise in determining the amount of tax that has been paid with respect to a particular distribution by a corporation that has paid AMT. However, under the tracking-tax-paid approach, adding minimum taxes to the SCA can be done directly. As indicated in note 26, the amount added to the SCA would be adjusted to reflect the maximum 31 percent rate at the shareholder level. Indeed, the need to allow imputation credits with respect to corporate AMT is an important reason for preferring the tracking-of-taxes-paid approach to a tracing-of-taxable-income approach under the credit limitation system.

25. The corporate AMT also seems appropriate under a compensatory tax. While a compensatory tax would prevent the passthrough of preferences to shareholders, it would not ensure that corporations pay some level of tax on retained income.

Imputation credits attached to a dividend represent tax prepaid at the corporate level and thus should be allowed for purposes of the individual AMT.

Example. A shareholder with a 31 percent marginal rate has $100 of AMT preference income, a $100 gross dividend, and a $31 imputation credit. Her AMTI is thus $200. She should owe only $17 in AMT ($48 of tax less the $31 imputation credit). Mechanically, this can be accomplished by computing her regular tax for AMT purposes as zero ($31 of tax less $31 imputation credit), but allowing the full imputation credit in computing tentative minimum tax. Thus, her tentative minimum tax is $17 ($48 − $31) and her AMT is $17 ($17 − 0).

Similarly, we recommend that excludable dividends not be viewed as preference income for individual AMT purposes under the dividend exclusion and CBIT prototypes. See Section 2.E and Section 4.D.

26. Although the AMT rate is 20 percent, compared with the maximum shareholder rate of 31 percent, corporate AMT payments are not added dollar-for-dollar to the SCA but instead, like regular tax, are reduced to reflect the difference between the corporate and shareholder rates. This rule is necessary because corporate AMT payments give rise to an equal AMT credit that offsets regular corporate tax at the 34 percent rate.

Example. A corporation invests $100 in an asset that will produce $100 per year for 2 years. As a deferral preference, the corporation is entitled to expense the asset in the first year.

Year	Cash flow	Taxable income	AMT	Regular tax before credit	AMT credit	Tax due	Cummulative SCA
1	100	0	20	n/a	n/a	20	17.44
2	100	100	n/a	34	20	14	29.65

At the end of year two, the corporation has an SCA of $29.65 and $66 of retained earnings. The corporation distributes $66 to shareholders, and no additional tax is due. If the AMT were instead added to the SCA dollar-for-dollar, the corporation would have an SCA of $32.21 and excess credits of $2.56.

27. Mechanically, the limitation on additions to the SCA allows distributions by the U.S. corporation out of earnings attributable to dividends from the foreign corporation to be treated in the same manner as distributions out of earnings attributable to preference income from U.S. sources.

28. IRC § 901.

29. Section 2.C discusses a shareholder level exclusion of foreign source income.

30. Continuing to tax income distributed to shareholders but preserving the benefit of preferences for tax-exempt shareholders under a compensatory tax system would require making imputation credits attributable to the compensatory tax fully refundable to tax-exempt shareholders. If policymakers were to choose to tax preference and foreign income as well as nonpreference income received by tax-exempt shareholders, a compensatory tax should be adopted with nonrefundability of credits to tax-exempt shareholders. This result cannot be accomplished under a credit limitation system without a compensatory tax. Such a compensatory tax system might be limited to preference income, but this would require separate tracking of foreign source income, which could continue to be paid free of U.S. tax to tax-exempt entities. Alternatively, if, contrary to the recommendations here, one chooses to tax neither preference nor nonpreference income distributed to tax-exempt shareholders, credits should be made refundable to tax-exempt shareholders; a system of refundable credits could be provided with either a compensatory tax or a credit limitation system. Refundability, however, would cause significant revenue loss.

31. See also Section 6.D for a discussion of an alternative approach under an integrated system that could be designed to maintain the overall level of tax revenues collected on corporate capital supplied by tax-exempt entities and achieve greater neutrality between the tax burden on their debt and equity capital.

32. Assume, for example, that a U.S. corporation with 1,000 shares outstanding of a single class of stock and an SCA balance of $2,000 makes a distribution of $10 per share and designates $2 per share as the applicable imputation credit with respect to each share. One hundred of the corporation's shares are owned by a foreign person subject to U.S. withholding tax at a rate of 15 percent under an applicable tax treaty. The foreign shareholder will be subject to U.S. withholding tax of $150 on the distribution of $1,000 (100 shares × $10 distribution × 15 percent withholding tax). The corporation will reduce its SCA by $2,000, although the foreign shareholder cannot offset the imputation credit against the U.S. withholding tax.

33. Consideration might be given to allowing a shareholder to carryforward unused imputation credits for some period of time, such as 5 years. Such a carryforward would add complexity, but should serve to enable virtually all shareholders subject to original tax rates below 31 percent and those currently in a tax-loss position to use any excess credits.

34. If imputation credits were fully refundable to all taxpayers, corporations and their shareholders would have no tax incentive to develop strategies for directing the credit to particular taxpayers. Because fully refundable credits would be equally valuable to all taxpayers, taxpayers would be indifferent to the form of a distribution, e.g., a $69 dividend carrying a $31 credit versus a $100 dividend carrying $0 credit or $100 of interest or other income such as rent or wages. However, in accord with the recommendations of Chapters 6 and 7, this prototype does not permit refunds of credits to tax-exempt or foreign shareholders. Credits thus would be available only to offset tax liability the taxpayer would otherwise owe on the dividends or other income. As a result, certain taxpayers, e.g., tax-exempt and foreign shareholders, would not be indifferent between receiving a dividend carrying a credit and a higher cash dividend distribution because to them the credit would not be the equivalent of cash.

If the alternative tax on investment income, described in Section 6.D, were adopted, imputation credits would be used by tax-exempt entities to reduce or eliminate that tax and the incentives for streaming would be reduced.

35. One difference is that the imputation credit prototype allows low-bracket shareholders to use excess credits to offset tax on other income.

36. New Zealand requires a corporation generally to frank all dividends paid during a year to the same extent even if the dividends relate to different classes of stock. A corporation may change its franking ratio during a year only if an officer of the corporation declares that the change is not "part of an arrangement to obtain a tax advantage" and the corporation notifies the tax authorities of the change.

Australia has adopted several rules to prevent a corporation from underfranking a dividend. These rules require the corporation (1) to take into account all dividends that are paid on the same day, that have been declared but not yet paid, or that the corporation is committed to pay later in the same year (a "committed future dividend"), e.g., dividends on preferred stock, in allocating franking credits to a given dividend, (2) to frank a dividend that was a committed future dividend at the time of payment of an earlier dividend at least to the same extent as the earlier dividend, and (3) to frank a dividend at least to the same extent as any other dividend paid on the same day. These rules, however, do not prevent a corporation from franking an earlier dividend at one rate and franking a later dividend at a lower rate if the corporation is not committed to pay the later dividend or the later dividend is paid in the next year.

Additional anti-abuse rules might be adopted as necessary. See Appendix B for a discussion of anti-streaming rules adopted by certain of our trading partners.

37. The implementation of distribution-related integration may require certain adjustments to the treatment of qualifying reorganizations to reflect the shareholder credit system. One issue is whether the current law treatment of "boot" (money or property other than stock or securities in a corporate party to the reorganization) is appropriate under distribution-related integration. Under current law, a shareholder receiving boot in a reorganization recognizes gain equal to the lesser of the gain realized and the amount of boot received. If the receipt of boot has the effect of a dividend, gain recognized is taxed as a dividend to the extent of the shareholder's ratable share of the corporation's earnings and profits. Dividend equivalency is tested by treating a target shareholder as receiving only stock of the acquiring corporation and the acquiring corporation as then redeeming an amount of the shareholder's stock equal to the amount of boot received.

The current treatment of boot raises problems under distribution-related integration because of the rule that limits the amount of boot that is taxable to the amount of the recipient's realized gain. Under distribution-related integration, this would allow the distribution of preference income to high-basis shareholders without shareholder level tax. It also would allow the distribution of fully-taxed income to high-basis shareholders without a reduction in the SCA, so amounts in the SCA subsequently could be used to frank distributions of preference income. This is similar to the issue created by share repurchases. If policymakers adopt special rules for share repurchases, similar rules may be appropriate for boot. See Chapter 8.

38. Assume, for example, that a corporation has two active businesses, each generating a mix of taxable and preference income. If the corporation could isolate each of the businesses in a separate corporation but leave the entire SCA balance in one corporation, shares of the corporation without any SCA balance could be distributed to tax-exempt shareholders, and shares of the corporation with the SCA balance could be retained by taxable shareholders.

39. In April 1990, Representative Vander Jagt introduced legislation that essentially adopts this approach. H.R. 4457, 101st Cong., 2d. Sess. (1990). The Vander Jagt bill would allow a tax credit to a shareholder or bondholder equal to the "gross-up amount" included in the holder's income. A recipient of a cash dividend or interest payment from a C corporation would include the gross-up amount, as well the cash received, in income. However, the amount of the credit would be limited to a portion of the taxpayer's tax that equals the ratio of his interest and dividend income to his total income. A corporation would be required to attach credits to a payment of interest or dividends representing the same proportion of the corporation's post-1989 taxes as the ratio of the amount of the net dividend or interest payments bears to post-1990 undistributed earnings and profits. No deduction would be allowed for interest or original discount paid or accrued by a C corporation. See also note 1 in Chapter 4.

The ALI Reporter's recent integration memoranda also adopt such an approach. See American Law Institute, Reporter's Memorandum No. 3 (1991).

40. A bondholder credit system could be adopted either while retaining the current deduction for interest paid by corporations or in a system denying deductions for either interest or dividends at the corporate level. Retaining the deductibility of interest would require imposing a withholding tax on interest payments and allowing recipients a credit for such withholding. The following example shows the calculation of the imputation credit with and without an interest deduction.

> Example. For simplicity, this example assumes that the corporate rate is 31 percent. A corporation earns $100 of taxable income and agrees to pay $50 of after-tax interest. If no interest deduction is allowed, the corporation would pay tax of $31 and would add $31 to its taxes paid account. The taxes paid account would represent available imputation credits for both interest and dividends. The corporation could attach an imputation credit of up to $22.46 to the interest payment. The $8.54 remaining in its taxes paid account would fully frank its remaining after-tax earnings of $19.
>
> If an interest deduction is allowed but a withholding tax on interest is imposed, the corporation would have to pay gross interest of $72.46. Net of the 31 percent withholding tax ($22.46), the interest payment would be $50. Taking into account the $72.46 interest deduction, the corporation would have taxable income of $27.54 and would owe tax of $8.54. Thus, the total tax paid would be $31 ($22.46+$8.54). The corporation's SCA balance, which would be available only to frank dividend payments, would be sufficient to frank a dividend of its remaining after-tax earnings of $19.

41. Therefore, CBIT might be viewed, to some extent, as substituting taxation of the payor for taxation of the recipients. To illustrate the concept of substitute taxation, assume a manufacturer borrows $100 for one year and agrees to pay $10 of interest to the lender. Assume both the manufacturer and the lender have a 31 percent marginal tax rate. The manufacturer plans to use the $100 to produce a product that will provide a return sufficient to pay $110 to the lender at the end of the year. At the end of the year, the manufacturer sells the product for $115. Under current law, the manufacturer's taxable income is derived by deducting from its $115 of gross sales $100 for wages, materials, and other costs of producing the product, and $10 for interest expense. The manufacturer would be liable for tax of $1.55 ($5×.31), and would use the remaining $113.45 ($115−$1.55) to repay the $100 principal on the loan and the $10 interest, leaving an after-tax return of $3.45. The lender would pay $3.10 of tax on its interest income ($10×.31) and would receive an after-tax return of $6.90.

Under CBIT, the lender need only be paid $6.90 in interest. The manufacturer's taxable income would be determined by deducting from gross sales the $100 for wages, materials, and other production costs. Thus, the manufacturer would have taxable income of $15 ($115−$100) and would pay $4.65 of tax ($15×.31). The manufacturer would then use the $110.35 in after-tax gross receipts ($115−$4.65) to pay $100 in principal on the loan and $6.90 in interest to the lender. The lender would not include the $6.90 of interest it received in its taxable income, because the tax on that income was by the manufacturer. The manufacturer's after-tax return would be $3.45 ($110.35−$106.90), and the lender's after-tax return would be $6.90. Compared to current law, the manufacturer's $4.65 CBIT liability can be viewed as including the same $1.55 of income tax on the manufacturer, and an additional tax of $3.10 on the lender's interest income; CBIT substitutes an additional $3.10 of tax on the borrower for the income tax that current law would impose on the lender.

42. The fact that the imputation credit system taxes income at the shareholder's or lender's rate creates other differences between the two models. For example, no small business exception would be needed. The bondholder credit system, like an imputation credit system, also provides greater flexibility to change policy recommendations in the future. For example, relief could be provided to tax-exempt and foreign investors simply by permitting full or partial refunds of imputation credits. Compare Section 4.F. As with the imputation credit system, however, this flexibility is earned at the cost of substantial complexity.

43. It may be appropriate to retain the withholding tax for unfranked dividends and interest payments. The issue is the same as the treatment of taxable dividends and interest payments if no compensatory tax is imposed under CBIT. See Section 4.E.

44. Example. A corporation earns $100 of taxable income, pays tax of $34, and adds $29.65 to its SCA. See Section 11.B for a discussion of how the SCA balance is calculated. The corporation could elect to pay deemed dividends of up to $66 (($29.65/.31−$29.65) = $66). If the corporation declared a deemed dividend of $66, shareholders would include $95.65 in income and would be entitled to imputation credits of $29.65. Share basis would increase by $66.

45. Excess credits could be used to offset other tax liability, but would not be refundable, as with imputation credits attached to a cash dividend.

46. See Section 9.A for a discussion of the allocation of basis among shares.

47. The prototype also adopts a holding period requirement and extends certain other rules of current law. See Section 11.F. Those rules would apply to deemed dividends as well as to cash dividends.

48. The rule described in the text would not prevent a corporation from adopting a dividend policy under which it pays unfranked cash dividends. It would, however, prevent a corporation from both paying partially franked or unfranked dividends and using the elective DRIP. Neither of the two common reasons that might lead a corporation to pay partially franked or unfranked dividends arise in circumstances in which a DRIP would be useful. First, a corporation might want to distribute cash but have an insufficient SCA balance to frank all dividends fully. In that case, however, the SCA balance will be completely exhausted by the cash distributions, and the corporation will neither need nor be able to use the DRIP. Second, the corporation might want to retain an SCA balance to frank future distributions. If the corporation intends to retain an SCA balance for future use, however, it would not use the DRIP to reduce its SCA balance.

Chapter 12

1. See Treasury I, Vol 2, pp. 136-37, 140; and The President's 1985 Proposals, pp. 122-26. A partial or full deduction for dividends paid is often expressed in terms of a split rate system, in which distributed earnings face a lower tax rate than retained earnings. With a full dividend deduction, a split rate system results in a zero corporate tax rate for distributed earnings. With partial dividend deductibility, the effective rate of deduction is $(t_c - t_d)/t_c$, where t_c and t_d are, respectively, the tax rate on retained earnings (the corporate rate) and distributed earnings.

2. Although a dividend deduction could avoid extending integration benefits to tax-exempt and foreign shareholders by imposing non-refundable, corporate level withholding, such a system replicates the imputation credit discussed in Chapter 11. For example, the imputation credit prototype could be duplicated by withholding at a 34 percent rate and allowing credits at a 31 percent rate. The two systems may have different nontax consequences. See American Law Institute, Reporter's Memorandum No. 1 (1990), pp. 45-47.

3. See Section 13.H.

4. Compare Institute for Fiscal Studies (1991) and the Reporter's Study Draft proposals discussed in Sections 12.B and 12.C, which avoid this problem by imputing a deduction on equity capital rather than tracking actual dividend payments.

5. See Section 2.B. This account would restrict the dividends paid deduction to the amount of income that otherwise would have been taxed fully at the corporate level. For example, if a corporation paid tax of $34 under current law it should beallowed a dividend deduction of up to $100—the pre-tax earnings, not the after-tax amount of $66 added to the EDA. The difference occurs because the dividend deduction system operates on a pre-tax basis whereas the dividend exclusion system operates on an after-tax basis. Presumably, the corporate AMT be retained and the interaction between dividend deductions available for regular tax purposes and for AMT purposes would have to be addressed.

6. The following examples illustrate how such results would occur, absent a limitation mechanism similar to the EDA.

> Example 1. A corporation earns $100 of tax-exempt bond interest income in one year. The corporation has no additional earnings in the next year and distributes the $100 of exempt income it earned in the first year. The corporation has a dividend deduction of $100, creating a net operating loss that can be carried forward to shelter $100 of future retained taxable income from tax.
>
> Example 2. A corporation earns $100 of foreign source income and pays foreign taxes of $34 in one year. After the foreign tax credit, it pays no U.S. tax. In the second year, the corporation has no additional earnings but distributes $66. The corporation has a dividend deduction of $66, which creates a $66 net operating loss that can be carried forward to shelter $66 of future taxable earnings.

7. An alternative approach, suggested in The President's 1985 Proposals, would require the distributing corporation to report to shareholders the portion of the dividend deducted. The deducted portion would be fully taxable to the corporate shareholder. The nondeducted portion would be eligible for a 100 percent dividends received deduction. Thus a corporate shareholder would be entitled to a 100 percent dividend received deduction with respect to dividends received in excess of the distributing corporation's previously taxed earnings. This approach would preserve preferences until distributed out of corporate solution.

8. See Chapter 9, note 2.

9. See Institute for Fiscal Studies (1991) and the description in Gammie (1991).

10. While the proposal would reduce tax-induced distortions in corporate financing decisions, if capital gains from retained earnings were to receive very favorable tax treatment at the investor level the IFS proposal would tend to encourage retention.

11. Shareholders funds are defined as:

(1) shareholders' funds for the previous period, plus
(2) any new equity contributed, plus
(3) the AFCE allowance for the previous period, plus
(4) the taxable profits for the previous period, less
(5) the tax paid on those profits, less
(6) dividends and distributions to shareholders and capital repaid.

A new corporation would have shareholders' funds for the initial period equal to the value of the equity capital contributed by shareholders. Additional rules would be needed to determine an existing corporation's shareholders' funds on the date of introduction of AFCE.

12. The following example illustrates the difference between intercorporate equity and debt investments under the proposal. If Corporation A uses $100 raised from new equity to buy shares in Corporation B, shareholders' funds are $0 for A and $100 for B. If, on the other hand, A raised $70 from equity and $30 from debt to buy shares in B, A would have shareholders' funds of -$30. The negative AFCE allowance would reduce the interest deductible on the $30 of debt against A's profits.

13. See American Law Institute, Reporter's Study Draft (1989).

14. According to the Reporter's Study Draft new equity capital includes "all amounts paid in for stock or as shareholder contributions to capital after the date of this proposal." The critical distinction is between "accumulated" and "contributed" equity. Earnings on new "contributed" capital become "accumulated" capital, do not increase the QCC, and, therefore, do not qualify for a dividend deduction. The intent is to treat contributed equity capital in a manner consistent with new borrowing. That is, if the allowable rate for deduction were 7 percent, an increase in contributed equity of $1 million would generate $70,000 in dividend deductions. Earnings on the $1 million invested would not qualify for a dividend deduction.

15. An important difference between the IFS and Reporter's Study Draft proposals is that the former grants dividend relief to both accumulated and new equity, while the latter grants relief only to new equity. The Reporter's Study Draft distinguishes between accumulated and contributed equity. An allowable dividend deduction is computed as the product of new contributed equity and the allowable rate.

16. As a consequence, low-bracket investors would be subject to a lower tax burden on dividends than on nondividend distributions.

17. The four Reporter's Study Draft proposals include coordinating rules to ensure that any particular transaction is subject to no more than one of these rules. For example, the MTD is imposed only to the extent that a distribution does not trigger interest disallowance or a reduction in the capital base for the dividends paid deduction. The MTD also does not apply to the purchase of stock as a portfolio investment. A distribution does not trigger interest disallowance to the extent that it reduces the capital base for the dividends paid deduction.

18. See Chapter 10 and Section 13.B.

PART V

Chapter 13

1. See, e.g., Shoven and Whalley (1972), Shoven (1976), Ballard, Fullerton, Shoven, and Whalley (1985), and Fullerton, Henderson, and Mackie (1987).

2. See Gravelle and Kotlikoff (1989).

3. Whether these distortions in fact create significant efficiency costs depends on the response of business enterprises to the tax bias against incorporation. Gordon and MacKie-Mason (1991), analyzing data on individual business enterprises, find that changes in organizational form (between C and S corporations, and between S corporations, partnerships, and proprietorships) are sensitive to changes in tax rates and other tax policy incentives.

4. For example, some potential investments that benefit from corporate organization on account of liquidity of corporate securities or access to capital markets will not be undertaken even if they earn more (before taxes) than comparable investments in the noncorporate sector. Publicly traded partnerships, including master limited partnerships with units traded on organized exchanges, can have the liquidity of publicly traded corporations without the corporate taxes if they limit their investments to certain types of activities, principally real estate and natural resources. REITs, REMICs, and RICs avoid a second level of tax provided they satisfy certain restrictions on assets and business activities. Alternatively, businesses may elect S corporation status. This allows them to retain some of the benefits of incorporation, but at the expense of conforming to certain restrictions. For example, S corporations have limitations on the number of investors they can have and the type of stock they can issue. See IRC § 1361(b).

5. In addition to corporate domestic income as a percentage of net national product, mentioned earlier, Figure 13.2 shows gross domestic product of all corporations and nonfinancial corporations, relative to gross domestic product; and gross domestic product of nonfinancial corporations relative to GNP, from 1950 to 1990.

6. Compare the declines in 1989 and 1990 in corporate profits relative to net national product (Figure 13.1) and in total income in the corporate sector relative to net national product, gross domestic product and gross national product (Figure 13.2) with the stability in income of proprietorships and partnerships relative to net national product (Figure 13.1).

7. S corporation income here is measured consistent with pre-1987 figures.

8. In the Midsession Review of the Budget (1990), estimated corporate receipts were decreased by approximately $7.5 billion to reflect revisions of the 1986 Act's effect on corporate income taxes and the greater than anticipated use of Subchapter S filings by corporations.

9. A bias would remain, however, if business tax preferences and losses that reduce the effective tax rate on noncorporate income did not pass through corporations to their shareholders.

10. A common rule of thumb is that the accrual-equivalent tax rate on capital gains is about one-fourth the statutory rate. See Poterba, "Tax policy and corporate saving" (1987) and the references therein. This adjustment captures reductions attributable to deferral and to the fact that the basis of inherited property is stepped up to fair market value (eliminating the tax on capital gains accrued before the holder's death).

11. For example, in the late 1970s, marginal tax rates on individuals were as high as 70 percent for unearned income, while the top marginal rate on corporate income was 46 percent and there was a 60 percent exclusion for long-term capital gains. This created an incentive in some cases to shift income into corporations, because the combination of the corporate tax rate and the effective capital gains rate was lower than the individual tax rate on the same amount of income. See Feldstein and Slemrod (1978). This was particularly likely to be true for corporations with income low enough to take advantage of the graduated corporate rate structure.

12. In comparing corporate and noncorporate investments, however, the degree of bias may be reduced by the existence of accelerated depreciation allowances. The relative importance of those allowances depends upon the marginal business level tax rate facing the corporate or noncorporate enterprise. In the case of the debt-equity choice, the focus is on a corporation contemplating the best method to finance that portion of net investment that is not being funded by the government through a policy of accelerated writeoffs. The existence of accelerated allowances is immaterial to that choice.

13. In certain special cases, however, debt may not enjoy a tax advantage over equity. Consider, for example, a corporation whose tax liability is determined under the AMT. That corporation faces a 20 percent corporate income tax rate. Thus, if the accrual-equivalent capital gains rate were sufficiently low relative to the shareholder tax rate on interest income, equity might be the tax preferred form of financing for the minimum tax corporation.

Because statutory corporate tax rates are graduated, a corporation with taxable income under $75,000 also would face a relative low (15 to 25 percent) corporate tax rate. For such a corporation, equity is less tax-disadvantaged than for corporations with larger profits that face the 34 percent statutory tax rate. In addition, a corporation with a substantial net operating loss can be thought of as having a low corporate tax rate and, therefore, as deriving little benefit from debt as opposed to equity financing.

14. The idea that debt can improve managerial incentives is at the core of Jensen's (1986) "free cash flow" theory, a prominent explanation of the increase in debt financing. Jensen contends that managers, if given the leeway, will take advantage of the inability of suppliers of funds to ascertain whether the firm is investing efficiently. Managers may squander cash flow by investing for their own benefit in projects with negative present value. An arrangement in which outside lenders hold debt and managers hold the residual claims minimizes this misuse of cash flow. Higher productivity (and, hence, shareholder profitability) could result from better managerial incentives. Some studies providing empirical evidence in support of this proposition are reviewed in Bernanke (1989).

This theory is subject to challenge, however. While debt financing is one way to mitigate the problem Jensen describes, it may not be the best option. If the objective is to make managers bear more residual risk, other means could be used (including incentive-based management compensation or reform of the oversight role, which in principle is exercised by boards of directors). Tax considerations have likely played a role. If taxes have contributed to increased debt, then high debt levels may not be the most efficient way to operate the firm.

15. This is true to the extent that debt is costly to renegotiate. See Gertler and Hubbard (1990). The idea is that managers should be made residual claimants only on the component of profits they can influence: the firm specific component. For example, managers should not be punished if the business does poorly during a recession but no worse on average than its competitors.

16. See Warshawsky (1991).

17. Looking at changes in debt to asset ratios in the "upper tail" (the ninetieth percentile corporations) reveals that some firms are close to having negative net worth on a market-value basis.

18. See Bernanke and Campbell (1988), Bernanke, Campbell, and Whited (1990), and Warshawsky (1991).

19. The empirical evidence on the effect of taxes on corporate borrowing decisions is mixed. Studies by Ang and Peterson (1986), Long and Malitz (1985), Bradley, Jarrell, and Kim (1984), and Marsh (1982), for example, fail to find plausible or significant tax effects. Other studies, in contrast, find significant relationships between tax policy variables and corporate borrowing. See, e.g., Auerbach (1985), Bartholdy, Fisher, and Mintz (1985), MacKie-Mason (1990), and Masulis (1983). At least two studies have directly estimated the responsiveness of corporate debt financing to changes in the tax advantage of debt. Nadeau (1988) estimates that a 1 percent increase in the tax advantage of debt relative to equity will cause a 0.2 percent increase in the fraction of external funds obtained by issuing debt. Rangazas and Abdullah (1987) estimate that a 1 percent increase in the tax advantage of debt relative to equity will cause a 0.12 percent increase in the debt to value ratio in the short run, and a 0.4 percent increase in the debt to value ratio in the long run.

20. This argument is made formally in Gertler and Hubbard (1991).

21. Some financial economists have maintained that tax parameters are irrelevant for dividend payout decisions, arguing that share prices of dividend paying firms are set by investors who face equivalent (typically zero) tax burdens on dividends and capital gains. See, e.g., Miller and Scholes (1978).

22. See, e.g., Bhattacharya (1979) and Miller and Rock (1985).

23. The new view (sometimes described as the "tax capitalization" or "trapped equity" approach) is developed in King (1977), Auerbach (1979), and Bradford (1981). See also the survey in Poterba and Summers (1985).

24. A temporary change in the dividend tax rate would change both dividend payments and investment incentives because of intertemporal substitution.

25. Again, investment incentives are only affected by transitory changes in investor level dividend tax rates.

26. Under the new view, other tax factors such as the corporate tax rate and capital cost recovery allowances affect the corporation's dividend distributions and the investment policy. To understand why, under the new view, permanent dividend taxes do not affect investment incentives, one must recognize that this view assumes that retained earnings provide the funds for marginal corporate equity financed investment. Consider, for example, a corporation that wants to invest $1 of capital by retaining an additional dollar of earnings. To retain the dollar, the corporation must reduce dividends by $1. At a 20 percent marginal individual income tax rate, the $1 of dividends foregone represents $0.80 net of the personal level tax on dividends, so $0.80 represents the cost of the investment in terms of dividends foregone. In the following period, suppose the investment earns a 6.4 percent pre-tax return, leaving $0.043 to distribute to the shareholders after paying corporate tax

at a 34 percent marginal corporate income tax rate ($0.043 = 0.064 \times (1-0.34)$). Upon distribution, the shareholder receives a net dividend of $0.034, after paying the 20 percent tax on the dividend distribution ($0.034 = 0.043 \times (1-0.20)$).

In determining investment incentives, however, it is the return to the shareholder relative to the cost of the investment that is relevant. In our example, the investment costs the shareholder only $0.80 in terms of foregone dividends, since that is how much she would have had to invest if the $1 had been distributed to her rather than reinvested within the corporation. Consequently, the rate of return relevant for determining whether the investment should be undertaken is 3.4 percent divided by 80 percent (4.3 percent), the pre-dividend tax return. Because the cost of the investment is always reduced by the dividend tax in exactly the same proportion that the return from the investment is reduced by the dividend tax, the dividend tax does not affect investment decisions under the new view.

The new view does assume, however, that share appreciation on investments financed by retained earnings is subject to capital gains tax. The effective accrual tax rate on capital gains does affect investment incentives, even under the new view. To see why, assume that the effective accrual tax rate on capital gains is 6 percent. When the corporation retains a dollar, the investor owes capital gains tax of $0.06*q, where q gives the share appreciation caused by $1 of retained earnings. We assume that the firm pays dividends, so that q must equal 0.851 ($0.851 = (1-0.2)/(1-0.06)$) to insure that shareholders are just indifferent between dividends and retained earnings. Thus, the shareholder pays capital gains tax of $0.051, thereby sacrificing a total of $0.851 in after-tax income to make the investment of one dollar. In the next year, the investment pays a dividend of $0.043, of which the investor keeps $0.034 after paying taxes at a 20 percent rate. To measure the investor's after-tax rate of return, we must adjust for the fact that only $0.851 was sacrificed rather than $1. As a result, the investor earns a 4 percent rate of return ($0.04 = 0.034/0.851$) after taxes. Note, however, that since the investment yields 4.3 percent before investor level taxes, the investor level tax rate is simply the 6 percent effective tax rate on capital gains ($0.04 = 0.043*(1-0.06)$). Thus, the capital gains tax, but not the dividend tax, reduces the investor's incentives under the new view.

27. Under the new view, managers are assumed to maximize shareholder value, and corporations can be described as "immature" (with desired investment spending exceeding internal funds) or "mature" (with internal funds exceeding desired investment spending). Immature firms use their available internal funds from retained earnings, then seek more costly external finance. They would never pay dividends and issue new shares at the same time. Investors in mature firms must be indifferent at the margin between receiving a dollar in dividends or receiving a capital gain on the reinvested dollar. If the value of an additional dollar of investment in the firms is denoted by q, the investor must be indifferent between receiving a dividend of $1—valued at $1-m$, where m is the investor level tax on dividends—and a capital gain of q dollars—valued at $q(1-z)$, where z is the investor level accrual-equivalent tax rate on capital gains. Hence, $1-m=q(1-z)$, so that $q=(1-m)/(1-z)<1$. Under certain assumptions, q is related to the ratio of the market value of the firm to the replacement cost of the firm's capital stock. Hence, the dividend tax is capitalized in share values (i.e., decreasing m would increase q and the value of the firm).

28. Under the traditional view, dividends offer nontax benefits to shareholders, so that tax-disfavored dividends are not a cheaper source of funds for the firm than external finance. Using the notation of the previous note, $q=1$, and investor level dividend taxes are not capitalized in share values.

29. See Poterba, "Tax policy and corporate saving" (1987). The Tax Reform Act of 1986 is assumed in the analyses discussed in this chapter to have increased the payout ratio from the 0.61 value reported by Poterba to 0.73 under current law.

30. Statistical analysis is difficult because it is often difficult to isolate changes in tax rates on income from dividends that occur independently of changes in tax rates on nondividend income (which would affect the required return on corporate equity, share values, profits, and dividends in equilibrium).

31. Brittain (1966) analyzes data on U.S. corporations from 1920 through 1960. For the corporate sector as a whole, he finds that in the short run (first year) a 1 percent increase in dividend tax rates would reduce the dividend payout ratio by 0.18 to 0.42 percent. As corporations gradually adjust to the new tax system, they respond more fully, and in the long run the behavioral responses are larger, ranging from 0.61 to 1.02 percent. Brittain concludes that the dividend tax rate explains dividend payout better than any of a variety of measures of the tax penalty on dividends relative to capital gains.

Feldstein (1970) examines the dividend payment behavior of British firms from 1953 through 1964, and finds that payout decisions were sensitive to the tax penalty on dividends relative to capital gains. Feldstein finds that in the short run (first year) a 1 percent increase in the tax penalty on dividends relative to capital gains (measured as the opportunity cost of retentions in terms of foregone dividends) will reduce the dividend payout ratio by between 0.27 percent and 0.68 percent. In the long run, Feldstein's estimates are close to 1.0.

King (1971, 1972) examines data on British corporations from 1949 through 1967. He finds behavioral responses that are lower than Feldstein's by about one-half. However, Feldstein (1972) countered that King's estimates are biased downward because of data problems, and maintains that the true response is closer to his own original estimates than to King's estimates.

Poterba and Summers (1985) also examine data on British firms, using information through 1983. They find that dividends are very sensitive to the tax penalty variable. They estimate that a 1 percent increase in dividend tax rates would reduce dividend payout rates by 0.18 to 0.54 percent in the short run and by 1.03 to 2.6 percent in the long run.

Poterba, "Tax policy and corporate saving" (1987) provides estimates based on data for the United States for the period 1948 through 1986. Poterba estimates short-term responses in the dividend payout ratio with respect to the dividend tax penalty ranging from 0.61 to 0.78 percent. In the long run, Poterba's elasticities range from 1.56 to 4.00 percent.

Another type of evidence comes from studies of changes in asset prices in response to taxes. Such studies attempt to test whether investor level dividend taxes are capitalized in share prices. Poterba and Summers (1985) studied the reaction of prices of British stocks to the announcement in 1970 that an integrated tax system would replace the double taxation of dividends. They found no significant increase in stock prices, suggesting that dividend taxes were not capitalized into share values.

32. This estimated sensitivity, in principle, could reflect investors' perceptions that dividend tax changes are temporary. Even in the new view, a temporary decrease in dividend tax rates would increase dividend payout. Poterba and Summers (1985) argue, however, that empirical evidence is consistent with an effect on payout of "permanent" dividend tax changes.

33. See Shoven (1987) and Poterba, "Tax policy and corporate saving" (1987).

34. The calculations follow Poterba (1987), and are based on tabulations of the COMPUSTAT Industrial and Research files.

35. In different contexts, see Lintner (1956), Easterbrook (1984), Jensen (1986), Gertler and Hubbard (1991).

36. See the discussion in Fazzari, Hubbard, and Petersen (1988) and Hubbard (1990).

37. Empirical evidence in support of the proposition that capital income taxes affect investment is more conclusive than for the case of saving. Modern theoretical models of business fixed investment build on early work by Jorgenson (1963), which demonstrated a link between capital spending and the cost of capital, which in turn depends in part on tax rates. Initial empirical evidence by Hall and Jorgenson (1967) bolstered this view. Criticism of the Hall-Jorgenson approach by Eisner and Nadiri (1968) and Eisner (1969) (see also later work by Chirinko and Eisner, 1983) centered on the Hall-Jorgenson approach of combining output and cost of capital effects in a single term. In this work by Eisner and others, the cost of capital effect in isolation was small. A significant effect of taxes on investment spending has been demonstrated in recent models using a range of underlying theoretical approaches. See, for example, Summers (1981), Feldstein (1982), Feldstein and Jun (1987), Fazzari, Hubbard, and Petersen (1988), and Auerbach and Hassett (1990, 1991).

38. See Shoven and Whalley (1984) for a discussion of computable general equilibrium models.

39. The assumptions underlying the models were made to conform to each other whenever possible. Common assumptions include inflation rates (3.5 percent), asset holding periods (seven years), share of capital gains excluded from tax through step up in basis at death (two-thirds), historical dividend-payout ratios (two-thirds of the real return), and historical debt shares (40 percent for corporations, 34 percent for noncorporate enterprises, and 38 percent for owner occupied housing). Each model generally characterizes the production technologies in a particular industry in a similar way, and where possible the models assume consistent behavioral responses of dividend-payout ratios and debt to equity ratios to changes in taxes. Only Federal taxes on capital income are taken into account in measuring investment incentives.

40. By taxing distributions out of tax-favored or foreign-taxed income, a compensatory tax can significantly offset the efficiency gains otherwise resulting from integration. In particular, had a compensatory tax been incorporated into the CBIT prototype (rather than the investor level tax actually recommended), the decision to retain, rather than distribute, current earnings would be as distorted by tax considerations as under current law.

41. The analysis of corporate borrowing in the model is based on Nadeau (1988). He estimates an elasticity of the fraction of total external financing in the form of debt to the difference between the real rate of return required on equity and the real interest rate of 0.224. The representation of corporate borrowing in the model is consistent with an elasticity of the debt

to asset ratio with respect to the tax advantage of debt of 0.3. Nadeau measures the tax advantage of debt as $1-[(1-t_c)(1-t_e)/(1-t_d)]$, where t_d is the tax rate on debtholders, t_c is the corporate tax rate, and t_e is the effective tax rate on the real return to equity (including the benefit from the preferential treatment of capital gains). Rangazas and Abdullah (1987) have estimated that this elasticity is about 0.4 in the long run, somewhat larger than the behavioral response assumed in the model used in this Report.

42. The gain to shareholders from a dollar distributed as a dividend relative to an additional dollar of retained earnings is given by $(1-m)/(1-z)$, where m is the tax rate on dividends and z is the accrual-equivalent tax rate on capital gains. The model assumes an elasticity of the dividend payout ratio with respect to this measure of relative after-tax values of approximately unity. This estimate is conservative. For example, Poterba (1987) estimated the long-run elasticity to be in the range from 1.6 to 4.0, while Feldstein (1970) estimated long-run elasticities ranging from 0.85 to 1.33.

43. In all calculations, noncorporate business is assumed to be financed using 34 percent debt, and owner-occupied housing using 38 percent debt. These calculations are based on information from Balance Sheets for the U.S. Economy, Board of Governors of the Federal Reserve System, various issues.

44. In fact, because nominal interest payments are deductible, the effective marginal tax rate on debt-financed investments is negative in these calculations.

45. These calculations assume that retentions are never distributed. Thus, they may overstate the difference between the taxation of dividends and retentions. This assumption is probably appropriate for the calculations below, however, since incentive effects in these calculations are based on a marginal expansion of the capital stock. Retained earnings used to finance such an expansion would be retained indefinitely.

46. In the scaled-tax-rate calculations, and compared to current law, all prototypes reduce slightly the overall average cost of capital for the economy, and encourage additional savings and investment. The small reduction in the overall average cost of capital is caused by the reduction in the premium that corporate investments must earn to compensate investors for tax-induced corporate financial distortions. The direct tax cost of investment has, by assumption, remained fixed at its current law level. Since CBIT reduces financial distortions most significantly, it generates the largest reduction in the overall average cost of capital. This effect is not the focus of the present analysis, however.

47. The incidence of the corporate income tax is discussed in detail in Section 13.G.

48. Mackie (1991) describes the technical details of the model outlined in this section. The model is based upon Fullerton and Henderson (1989).

49. See, e.g., Gordon and Malkiel (1981), Fullerton and Gordon (1983), and Gertler and Hubbard (1990).

50. Even though in the scaled-tax-rate calculations the integration prototypes may leave constant the effective tax rate on investment, they still might encourage capital formation by reducing tax-induced distortions in corporate financial policy. Although small in an absolute sense, this effect may be large relative to the other gains brought on by the integration prototypes. Nonetheless, the static, single period calculations reported in the tables do not incorporate such an effect.

51. We use a modified version of the Mutual Production Model introduced by Gravelle and Kotlikoff (1989).

52. Corporate financial behavior in the MPM is based on CES functional forms with an elasticity of dividend payout ratio with respect to the tax penalty on dividends relative to capital gains equal to -3.0, and an elasticity of the leverage ratio with respect to the tax advantage of debt relative to equity equal to 0.3. Thus, the financial behavior in the MPM is consistent with, but not identical to, that assumed in the augmented Harberger model described earlier. For technical details of the MPM, see Gravelle (1991).

53. As statutory tax rates rise to make the distribution-related prototype revenue neutral, the tax advantage of debt relative to equity also rises because the higher tax rates increase (1) the value of deducting nominal interest, and (2) the tax rate on purely inflationary capital gains. At the set of tax rates needed for revenue neutrality, these two effects, combined with a relatively large distortion in dividend policy, are sufficient to counteract the effect of the dividend exclusion or credit. As a result, relative to current law the tax benefit to debt rises, and corporations actually increase slightly their use of debt.

54. The portfolio allocation model is described in Galper, Lucke, and Toder (1988).

55. Households hold debt and corporate equity, directly and indirectly, through certain pension holdings. The household allocations of debt and corporate equity in Table 13.9 reflect direct holdings. Pension holdings of debt and corporate equity are shown separately.

56. Household wealth includes small net holdings of foreign equity. As a result, total wealth slightly exceeds the value of total physical capital, so shares can differ between the top and middle panels of Table 13.9.

57. Though not shown, the PA model also simulates changes in portfolio shares across income groups. The shareholder allocation, imputation credit, and CBIT prototypes shift stock ownership from high-income to low-income groups; the dividend exclusion prototype shifts stock holdings to higher-income groups. In all cases, the shifts are quantitatively small. Larger cross-household shifts in taxable debt accompany the prototypes, especially CBIT. Broadly speaking, all of the prototypes reduce the share of total debt held by low-income groups, while raising the share held by middle- and high-income groups.

58. Note that this can result simply because existing businesses in the noncorporate sector decide to incorporate. It does not necessarily imply a change in ownership of assets.

59. Both the augmented Harberger model (AH) and MPM simulations suggest that each integration prototype would improve economic welfare. The models also suggest possible gains at both real and financial margins. Nonetheless, there are substantial differences between these two models' results. Perhaps most noticeably, the MPM produces much larger shifts in physical capital and in economic welfare than does the AH model. There are some key differences in the models' predictions about corporate financial policy, real capital shifts, and welfare changes, as described below.

Changes in corporate financial policy. For a given prototype and financing mechanism, the two models predict very similar changes in the corporate dividend payout ratio. In the lump-sum calculations, furthermore, the two models predict fairly similar changes in the corporate leverage ratio. In contrast, with the scaled-tax-rate replacement mechanism, the two models predict somewhat different changes in the corporate leverage ratio, especially under the two distribution-related prototypes. Such differences can be traced to the fact that the two models (1) start with somewhat different statutory rates, (2) use slightly different behavioral responses in estimating corporate financial behavior, and (iii) have different equal-tax-yield requirements.

Changes in capital allocation. The MPM generally produces larger shifts in physical capital than does the AH model. This difference reflects in part the MPMs greater scope for substitutability between corporate and noncorporate resources. The greater substitutability stems from two sources: (1) a much larger implied substitution elasticity between corporate and noncorporate business in each industry; and (2) a corporate-noncorporate choice in the provision of rental housing that is not considered in the AH model.

Changes in welfare from improved consumption. The MPM predicts larger gains from improved consumption choices. This difference is due principally to the MPM's greater shifts in capital (and other resources) discussed above. The greater substitution between the corporate and noncorporate form in the MPM means that, because investors are quite sensitive to tax differences, current law does more to distort the allocation of real resources in that model than in the AH model. Consequently, relieving the tax distortion produces a larger gain in the MPM than in the AH model.

Changes in welfare from corporate financial policy. The MPM generally produces larger changes in welfare from changes in corporate debt and dividend policy. Some differences between the models' welfare results reflect differences in the predicted changes in the leverage and dividend payout ratios, as discussed above. In addition, for each prototype the MPM has a larger fraction of the economy's stock of capital allocated to the corporate sector under current law than does the AH model. Thus, the same per unit financial distortion would produce a larger absolute (i.e., dollar) loss in the MPM than in the AH model.

60. Our gains also are on the same order of magnitude as those estimated for the 1986 Act. See, e.g., Fullerton, Henderson, and Mackie (1987).

61. See Harberger (1966), Shoven (1976), and Fullerton, et al. (1981).

62. See Fullerton (1984).

63. See Fullerton and Henderson (1989).

64. Others also have emphasized the role of debt finance and capital gains taxes in reducing the size of the corporate tax wedge, and so reducing the efficiency cost of the corporate tax system. See, e.g., Gordon and Malkiel (1981) and Stiglitz (1973).

65. The important differences are three. First, in this Report, only Federal income taxes distort investment decisions, while in Fullerton and Henderson, state and local income and property taxes also act to distort investment decisions. (All other things constant, this would tend to make the welfare gains from integration in Fullerton and Henderson larger than those in this Report.) Second, Fullerton and Henderson's calculations are based on the new view of dividend taxes while this Report uses the traditional view. (All else constant, this would tend to make the welfare gains from integration in Fullerton and Henderson smaller than those in this Report.) Finally, in this Report the model has been augmented to account for tax-induced financial distortions. (This would tend to make the welfare gains from integration, even those due to real resource allocation alone, smaller in Fullerton and Henderson than those in this Report.)

66. Fullerton and Gordon (1983), for example, estimate that eliminating the tax incentive for corporate debt would generate gains equivalent to about 0.8 percent of consumption, while Gordon and Malkiel (1981) estimate that it would generate gains of about 0.4 percent consumption.

67. Neither Gravelle (1989) nor Fullerton, Henderson and Mackie (1987) considered the welfare costs of distortions of corporate financial decisions.

68. Harberger (1977 and 1980) argues that evidence on rates of return on capital is consistent with capital mobility. On the other hand, Feldstein and Horioka (1980) found that domestic saving and investment rates moved too closely together in the 1960s and 1970s to be consistent with capital mobility. Feldstein and Horioka reasoned that if capital were perfectly mobile internationally, national savings rates should be independent of national investment rates. Capital would flow to wherever it received the highest return, and so returns would be equalized globally. Therefore, if saving increased in a country, rather than reducing interest rates below the global interest rate and thereby increasing investment at home, the additional saving would flow abroad. However, examining data from OECD countries, they found that, over long periods, national saving and investment rates were highly correlated. In a regression of national investment rates on national saving rates, the estimated coefficient on saving was statistically significant and close to unity. They interpreted this to mean there was very little international capital mobility, so that a one dollar increment to national saving produced almost a one dollar increment to national investment.

Since Feldstein and Horioka, there has been a series of papers examining the saving-investment relationship in time series and cross-section studies, generally with the intent of overturning their result. The result has, however, until recently, held up remarkably well for data from many countries over a long period. Recently, however, studies by Feldstein and Bacchetta (1989) and Frankel (1990) indicate that the close correlation between saving and investment may have broken down during the 1980s. Using data from the OECD countries, Feldstein and Bacchetta found that the coefficient on saving in a saving-investment regression is markedly lower for the 1980-1986 period than for prior years. Frankel used a long time series of U.S. data and found that the relationship between saving and investment held up well before 1980, but for the 1980-1987 period the estimated coefficient on saving is relatively small and statistically insignificant.

Several authors have pointed out that national savings and investment rates are both endogenous variables. Hence if there are exogenous variables that are correlated with both saving and investment, one could find a significant correlation between the two even in the presence of perfect capital mobility. See, e.g., Obstfeld (1986), Summers (1986), and Frankel (1986). Feldstein and Bacchetta (1989) rejected most of these explanations.

More recently, researchers have studied impacts of domestic capital market imperfections on capital flows. For example, Gertler and Rogoff (1990) present a model in which capital is perfectly mobile internationally, but capital market imperfections can lead domestic saving to be correlated with domestic physical investment. In their model, there is a domestic sector consisting of risky projects. There also is an international market for a riskless asset which yields a world rate of return. Foreigners can invest funds directly in the risky domestic projects, but because of asymmetric information they do not know how much of their funds are actually used in the project and how much reinvested in the international capital market. The probability of the project's success depends on how much money is actually invested in it. There is underinvestment of foreign funds in the risky domestic sector, but foreign investment increases with increased domestic investment in the risky sector. If saving increases, thereby increasing investment of domestic funds in the risky sector, foreigners will be willing to contribute more funds too. This may cause saving and investment to be correlated. While this model is stylized, it does point out that international mobility of capital in one market (for low-risk assets) need not imply that returns are equated internationally in markets for risky assets.

69. Most of the empirical evidence pertains to debt securities. When looking at securities (as opposed to saving and investment rates), the appropriate test is whether returns are equalized across national boundaries. To implement this test, one needs to define (and measure) the relevant returns that should be equalized. This is not always easy.

Mishkin, "Are Real Interest Rates Equal Across Countries" (1984), Mishkin, "The Real Interest Rate" (1984), and Mark (1985) found evidence against real interest parity. In a less direct test, Barro and Sala-i-Martin (1990) estimated a system of country real interest rate and investment equations derived from a macroeconomic model. They found some evidence that global factors, e.g., global stock returns, are more important in determining a country's real interest rate than country specific factors. Of course, real interest parity may not hold even in the presence of perfect capital mobility if there is an expected change in the real exchange rate or an exchange rate risk premium. A test for capital mobility that allows for the existence of expected changes in the exchange rate or exchange rate risk premia is whether covered interest parity holds. Frankel and MacArthur (1988) and Frankel (1990) present evidence that covered interest differentials have narrowed over time, and that they are currently small for major industrial countries.

The covered interest differential measures only the extent of institutional barriers and market imperfections that impede capital flows. It does not measure the substitutability of domestic and foreign assets in investors' portfolios. The uncovered interest differential is a better indicator of capital mobility capturing asset substitutability. The difference between the uncovered interest differential and the covered interest differential is the exchange rate risk premium, the size of which provides a measure of the substitutability of assets across currencies. Froot and Frankel (1989), Giovannini and Jorion (1987), and others have rejected uncovered interest parity, suggesting the presence of a risk premium. Frankel (1990) presents some evidence that much of these differences is accounted for by expected changes in real exchange rates rather than exchange rate risk premia.

To summarize, there appears to be substantial integration in asset markets for short-term debt. Of course, even if there is a high degree of capital mobility in these markets, imperfect substitution between these markets and other asset markets (for equity or long-term debt) could still be consistent with weak overall integration of capital markets.

Tests of equity market integration in the capital asset pricing model have generally rejected international integration. See, e.g., Stehle (1977) and Jorion and Schwartz (1986). This may be due in part to the sample period (which does not include much of the 1980s). French and Poterba (1991) stress informational problems as an explanation for imperfect international diversification in equity markets.

70. See Mutti and Grubert (1985) for details.

71. The model assumes not only that debt capital is more internationally mobile than equity capital, but also that debt is more important in cross-holdings of assets. In the model's calibration, 66 percent of foreign holdings of U.S. assets are in the form of debt, while 60 percent of U.S. holdings abroad are in the form of debt.

72. This is true even for shareholders that are tax-exempt institutions. Taxes borne by pension and life insurance funds reduce the incomes of their beneficiaries, and taxes falling on charitable and educational institutions reduce the services they can provide.

73. See, e.g., Harberger (1962), Shoven and Whalley (1972), Shoven (1976), Pechman (1987), and Gravelle and Kotlikoff (1989).

74. See Harberger (1962).

75. See Ebrill and Hartman (1982) and Gravelle and Kotlikoff (1989).

76. See, e.g., Stiglitz (1973). The risk of bankruptcy may constrain the use of debt to finance the marginal investment, and that risk plays an independent role in the effect of the corporate tax. See, e.g., Gordon and Malkiel (1981).

77. See, e.g., Harberger (1983), Mutti and Grubert (1985), and Pechman (1987).

78. See Young (1988), Murthy (1989), and Gravelle (1991).

79. This possibility seems likely for the United States since the corporate tax is not a residence-based tax. American multinationals pay taxes on repatriated income to the United States in excess of foreign taxes paid. The U.S. corporate tax, in fact, is both residence-based and source-based, since taxes on earnings retained and reinvested abroad can be deferred.

80. Other assumptions have sometimes been used by other analysts. While Pechman (1987) allocated the corporate income tax to all capital income, Pechman and Okner (1974) and Pechman (1985) used five different assumptions to allocate the corporate income tax: (1) to dividends, (2) to property income in general, (3) half to dividends and half to property income in general, (4) one-half to dividends, one-fourth to consumption, and one-fourth to employee compensation, and (5) half to property income in general and half to consumption. In its original (1987) study of tax burdens and in the (1988) update, the Congressional Budget Office allocated the corporate tax burden in two ways: (1) entirely to capital income and (2) half to capital income and half to labor income. The Joint Committee on Taxation has not attempted to allocate the burden of corporate income tax to individuals.

The assumptions correspond to those conventionally employed in contemporary analyses of the distributional implications of tax changes. Early analyses by the Department of the Treasury in the 1930s and 1940s allocated the burden of the corporate income tax by income class on the basis of dividends or stockholdings. More recently, Department of the Treasury analyses of the distribution by income class of federal income taxes have consistently allocated the burden of the corporate tax to owners of capital. In Blueprints, the corporate income tax was allocated on the basis of total capital income. Similarly, in constructing Family Economic Income, the Department of the Treasury has allocated the corporate tax to families on the basis of their total capital income.

81. The tax rates reflect the burden of the corporate tax borne by foreign investors and tax-exempt institutions, other than pensions, through their ownership of U.S. capital. The portion of the corporate tax falling on assets owned by pension funds is allocated to the individuals with rights to the pension reserves.

82. Family economic income is constructed by adding to adjusted gross income: unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside buildup on pensions, life insurance, and IRA and Keogh accounts; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. The economic incomes of all members of a family unit are summed to produce the family economic income used in the distributional analysis.

83. The rate of inflation is assumed to be 3.5 percent per annum.

84. The revenue estimates have assumed an average excludability rate of 56 percent, implying that 56 percent of the distributions of corporations will be excluded from income have tax credits attached that can be used by the recipient of the distribution to offset taxes. This rate consists of a base rate of 51 percent and an additional 5 percent representing carryovers of excess amounts in Earnings Distribution Accounts from prior years to exclude dividends in the current year.

The low average excludability rate is accounted for by the fact that many corporations that distributed income to shareholders have paid no (or little) tax on that income. That is, much of the income distributed represents preference or foreign source income not taxed at the corporate level. Moreover, many corporations whose income is taxed more fully have low dividend payout ratios. The assumed excludability rate of 56 percent is based on Department of the Treasury calculations.

85. The EDA is calculated as taxes after credits multiplied by $(1-t_c)/t_c$, where t_c is the corporate tax rate, to gross up the amount of income available to pay excludable dividends. For example, for income of $100 and taxes paid of $34, $66 is available to pay dividends. The EDA also is $66 [$(0.66/0.34)\times\$34$].

86. Thus, individuals cannot exclude dividends from foreign source income except to the extent that U.S. tax is paid.

APPENDICES

Appendix A

1. Treas. Reg. § 301.7701-2(a)(1). Two characteristics, associates and an objective to carry on business and divide the profits, are common to partnerships and corporations and are therefore not material in distinguishing between partnerships and corporations.

2. IRC § 7704.

3. IRC § 851 et seq.

4. IRC § 856 et seq.

5. IRC § 860A et seq.

6. Exceptions include: (1) interest on purported debt that is properly viewed as equity (see, e.g., IRC § 163(e)(5)), (2) interest on debt used to finance certain tax-favored income (see, e.g., § 265(a)(2)), and (3) interest that must be capitalized because the debt relates to the production of future income (see, e.g., IRC § 263A(f)).

7. The Code treats a distribution as a dividend to the extent of current and accumulated earnings and profits of the distributing corporation. Distributions that exceed earnings and profits are treated as a tax-free return of basis to the extent of the shareholder's basis in the stock. To the extent that the distributions exceed basis, they are generally treated as capital gains. IRC § 301(c).

8. Capital gains of individuals are subject to a maximum tax rate of 28 percent. IRC § 1(h).

9. A domestic corporation also is entitled to a dividends received deduction (in the percentage specified in IRC § 243) for the U.S. source portion of dividends received from a foreign corporation that is at least 10 percent owned by the U.S. corporation. The deduction is 100 percent for a wholly owned subsidiary whose income is all effectively connected with a U.S. trade or business. IRC § 245.

10. IRC § 385(b).

11. The data reflect corporate taxes at both the central government and local levels. Comparisons of corporate tax receipts for central governments only would be misleading because some countries have much greater corporate taxation at the local level than others. Organisation for Economic Co-operation and Development (1991), Table 13, p. 78.

Appendix B

1. We believe that the descriptions that follow are complete as of December 1991. They are based in part on secondary sources. We are grateful to those government officials, academics, and practitioners who gave us their comments.

2. The amount of the imputation credit is $[F/(1-.39)]\times.39$, where F equals the amount of the distribution from the franking account.

3. The amount added to the franking account each year is $(61/39\times T)+D$, where T is the total Australian tax paid by the corporation in the relevant period and D is the amount of franked dividends received from other resident corporations that period.

4. For example, an individual shareholder owns a share with a paid-up value of AU$1.00 and a market value of AU$2.50. The shareholder's basis in the share is AU$2.00. The corporation buys the share (and has taxable income sufficient to frank fully all dividends paid that year). If the buyback is off-market, then the difference between AU$2.50 (amount paid) and AU$1.00 (paid up value) is a dividend (AU$1.50). That part of the purchase price not treated as a dividend (the paid up value of AU$1.00) is consideration received in the sale. Thus, the shareholder also has a capital loss of AU$1.00 (AU$1.00 paid up value minus AU$2.00 basis). If the buyback is instead on-market, the total purchase price (AU$2.50) is consideration in the sale, and the shareholder has a capital gain of AU$0.50 (AU$2.50 minus AU$2.00 basis). The corporation, however, must debit its franking account by AU$1.50, the amount that would have been a dividend if the purchase were off-market.

5. The required franking amount equals: $CD\times[RFS/(TD+CFD+SDD)]$, where CD is the current dividend and RFS is the franking surplus. RFS is reduced by any unpaid dividends with an earlier reckoning day. (The reckoning day is normally the day that the dividend is paid, but sometimes dividends that are part of the same distribution are not paid on the same day. In that case the reckoning day is the day that the first of those dividends is paid.) TD is the total amount of dividends paid or to be paid on the same class of shares and under the same resolution as the current dividend. CFD is the amount of the committed future dividends (not in TD) at the beginning of the reckoning day for the current dividend. SDD (same day dividends) have the same reckoning day but are paid or to be paid under a different resolution or under the same resolution on a different class of shares.

6. Thus, the corporation pays a franking deficit tax equal to the franking deficit grossed-up at the corporate rate and then multiplied by that rate: $[FD/(1-.39)]\times.39$, where FD equals the amount of the franking deficit.

7. Implementation of an accompanying foreign investment fund regime recently was postponed to July 1, 1992. This regime is similar in purpose, though not in details, to the U.S. PFIC rules of IRC §§ 1291-1297.

8. For example, if a shareholder receives a taxable dividend of $100, he includes $125 in income and receives a Federal tax credit of $16.75. Assuming the provincial rate is 50 percent of the Federal liability, the $16.75 Federal credit reduces provincial tax liability by $8.38 ($16.75/2). The total tax saved as a result of the credit is $25.13.

9. The following table illustrates the Canadian system with respect to the business income of a Canadian corporation. (This analysis does not deal with the investment income of a Canadian private corporation, which is subject to a somewhat different regime.) The table assumes, for purposes of the provincial tax, that the dividend paying corporation is both resident in, and doing business in, Ontario, and that the individual Canadian shareholder also is resident in Ontario. Three cases are shown: a normal Canadian corporation, subject to a 28 percent Federal tax plus a 3 percent surtax and a 15.5 percent Ontario tax; a Canadian manufacturing company, subject to a 23 percent Federal tax plus a 3 percent surtax and a 14.5 percent Ontario tax; and a small business corporation subject to a 12 percent Federal tax on its business income (not exceeding $200,000 per year) plus a 3 percent surtax and a 10 percent Ontario tax. The shareholder is assumed to be subject to Federal income tax at the top rate of 29 percent (before credit) plus a 5 percent surtax, and an Ontario tax equal to 53 percent of the Federal tax (after shareholder credit). For simplicity, these rates do not reflect the Federal and provincial surtax on high-income individuals.

	Normal Corporation	Manufacturing Corporation	Small Business Corporation
Net income of Canadian corporation	100.00	100.00	100.00
Federal tax	28.00	23.00	12.00
Federal surtax (3%)	0.84	0.84	0.84
Ontario tax	15.50	14.50	10.00
Total Federal and provincial tax	44.34	38.34	22.84
Maximum distribution to shareholder	55.66	61.66	77.16
25 percent gross-up	13.92	15.42	19.29
Taxable income of shareholder	69.58	77.08	96.45
Federal pre-shareholder credit income tax	20.18	22.35	22.97
Dividend received credit (67% of gross-up)	9.28	10.28	12.86
Federal tax after shareholder credit	10.90	12.07	15.11
Federal surtax (5%)	0.55	0.60	0.76
Ontario tax (53% of pre-surtax, post-credit, Federal tax)	5.78	6.40	8.01
Total Federal and provincial shareholder tax	17.23	19.07	23.88
Total value of credit to shareholder (Federal credit plus .53% of Federal credit)	14.20	15.73	19.68
Value of credit as a percentage of gross-up	102.0%	102.0%	102.0%
Credit as a percentage of Federal and provincial corporate tax	32.0%	41.0%	86.2%

10. These amounts are indexed for inflation.

11. Assume, for example, that a regular corporation earns $25 of preference income and $100 of taxable income. Assume, in addition, that a regular corporation is subject to Federal tax at a net rate of 28 percent (i.e., after the provincial abatement) and that a shareholder is subject to Federal tax at a rate of 29 percent (both assumptions disregard surtaxes). Taking into account only Federal tax, the corporation pays $28 of tax. When net income of $97 is distributed, the shareholder includes $121.25 in income ($97 × 125 percent), has tax liability of $35.16 and is entitled to a credit of $16.25, reducing shareholder tax to $18.91. The total Federal tax burden on $125 of economic income is thus $46.91 ($28+$18.91), or 47 percent. Thus, the income has been taxed at a rate greater than either the shareholder or the corporate rate. If, on the other hand, the corporation had earned $125 of preference income and $100 of taxable income, the total Federal tax burden on $225 of economic income would be $46.91, or 21 percent.

12. Special rules apply with respect to dividends on redeemable preference shares.

13. When the avoir fiscal was enacted in 1965, the French corporate tax rate on distributed (and retained) profits was 50 percent. The 50 percent avoir fiscal percentage was chosen in order to provide shareholders with a partial imputation credit equal to 50 percent of the taxes actually paid by a corporation on distributed profits. When the corporate tax rate was reduced to 42 percent in 1988, however, the avoir fiscal percentage also was not reduced to preserve the 50 percent relationship between the avoir fiscal and actual corporate tax payments. Instead, the avoir fiscal percentage was maintained at 50 percent as a means of introducing a greater degree of integration. As a result, the avoir fiscal represented a greater percentage (69 percent) of actual corporate tax payments on distributed profits. With the further reduction of the tax rate on distributed profits to 34 percent for 1992, the avoir fiscal will represent almost the entire amount of corporate level tax paid on distributed profits.

14. Net operating losses generally may be carried forward for 5 years, although net operating losses attributable to depreciation may be carried forward indefinitely. If a net operating loss fully offsets taxable income in a carryover year, a dividend distribution out of carryover year income will incur the precompte mobilier. A corporation may elect, however, to spread a net operating loss carryover over the 5 year carryover period in order to leave some fully-taxed income in each year of the carryover period from which to make dividend distributions.

Alternatively, a corporation may elect to carry back over a 3 year period a tax credit calculated by applying to the amount of the loss the standard corporate tax rate in effect at the end of the loss year. The tax credit may be used to offset income tax liability on undistributed fully-taxed profits realized during the 3 year carryback period. Any excess credit remaining thereafter is refunded.

Net operating losses cannot be carried back to offset any portion of the prior years' income for which tax liability was satisfied using avoir fiscal or other tax credits.

15. Rather than separating income into fully-taxed and untaxed baskets, France effectively relies on the ability of French corporations to avoid the precompte mobilier out of retained earnings with respect to income taxed at rates less than 34 percent. For example, assume that a corporation has F1000 of gross income, F500 of which is taxable at 34 percent and F500 of which effectively is taxable at 19 percent, e.g., a dividend from a foreign corporation resident in a treaty country paid to a French nonparent corporation that is subject to a 15 percent foreign withholding tax. If the corporation distributes its entire after-tax income of F735, this amount will be subdivided into two parts: a dividend of F330, which has borne regular corporate tax, and a dividend of F405, which has not borne corporate tax. The precompte mobilier will be imposed on F405 at a rate of 50 percent, resulting in an additional tax liability of F202.50. Thus, the total tax liability of the corporation will be F467.50, and the corporation will be required to pay the additional F202.50 liability out of retained earnings.

As a practical matter, a corporation wishing to distribute tax-sheltered income will reduce the amount of its dividend so it can pay its precompte mobilier liability out of current after-tax income. In the above example, the corporation would pay a dividend of F600, equal to F330 (income that has borne regular 34 percent corporate tax) plus F270 (income that is subject to a precompte mobilier of 50 percent). The corporation's total tax liability would be F400, equal to F265 regular corporate tax plus F135 precompte mobilier.

16. The participation exemption results in an effective tax rate of (1) 2.55 percent on the gross amount of a dividend (including the amount of the avoir fiscal) received from a 10 percent-owned French subsidiary, and (2) 1.70 percent on the gross amount of a dividend (including the amount of a credit for foreign withholding tax) received from a 10 percent-owned subsidiary in a treaty country.

17. In some circumstances, a French company may elect to be taxed on all foreign branch income. In such cases, the precompte mobilier is not imposed upon distribution of the foreign branch income.

18. The purpose of the special rules is to avoid an effective tax surcharge that arose under pre-1990 law. Dividends received by a French holding company from a foreign subsidiary are exempt from French income tax in the hands of the holding company by virtue of the participation exemption. Prior to 1990, however, the foreign source dividend income was subject to the precompte mobilier upon redistribution by the holding company. Payment of the precompte mobilier by the holding company entitled the recipient to claim an avoir fiscal credit with respect to the redistribution. If the recipient was a French 10 percent shareholder of the holding company, however, the participation exemption would exempt the income again in the hands of the 10 percent shareholder. Thus, the avoir fiscal was not needed to offset income tax liability of the 10 percent shareholder with respect to the dividend income. Under pre-1990 law, moreover, the avoir fiscal could not be used to offset income tax liability of the 10 percent shareholder with respect to other types of income. Pre-1990 law did permit the 10

percent shareholder to use the avoir fiscal to offset any precompte mobilier liability that it might incur upon a subsequent distribution of preference income; if the 10 percent shareholder did not have sufficient preference income however, all or a portion of the avoir fiscal (which had been "paid for" by the French holding company) was lost.

19. The amount of the excess tax equals the amount distributed out of EK 50 (or EK 56), grossed-up to its pre-tax equivalent, and then multiplied by the difference between 50 percent (or 56 percent) and 36 percent (the distribution rate). Accordingly, if D equals distributions out of EK 50 (or EK 56), the corporation receives a refund of D/.50×.14 (or D/.44×.20). For example, if a corporation earns DM100 and pays tax of DM50, it will have DM50 in its EK 50 account. If it then redistributes DM50 out of EK 50, the corporation will receive a refund equal to DM14 (DM50/.50×.14).

20. The following table illustrates the application of the German split rate and imputation credit systems. For simplicity, the table ignores any surtaxes.

Income before taxes		DM100.00
Tentative corporate tax		DM50.00
Decrease in corporate tax on full distribution		DM14.00
Amount available for distribution		DM64.00
Withholding tax (25 percent)		DM16.00
Shareholder includes in income		DM100.00
Cash dividend	DM48.00	
Withholding tax credit	DM16.00	
Imputation credit	DM36.00	
	DM100.00	
Shareholder tax liability (53 percent rate)		DM53.00
Shareholder credit		DM52.00
Withholding tax credit	DM16.00	
Imputation credit	DM36.00	
	DM52.00	
Net amount due		DM1.00

21. The following equation converts pre-tax income subject to tax at some non-EK rate into equivalent amounts of pre-tax income subject to tax at the distribution rate (36 percent) and either the statutory rate (50 percent) or the zero rate: $.36X+(.5 \text{ or } 0)\times(Y-X) = T$, where Y equals the total amount of pre-tax income (known) subject to some non-EK rate, X equals pre-tax income subject to the distribution rate, $(Y-X)$ equals pre-tax income subject to either the statutory rate or zero rate, and T equals the amount of tax paid with respect to Y (known). Because X and $(Y-X)$ must be positive, the effective tax rate, T/Y, determines whether the equation must contain the statutory rate or zero rate (and whether the residual amount of income is ultimately converted into EK 50 or EK 0).

The following equations convert the pre-tax amounts, X and $(Y-X)$, into their after-tax EK amounts:

$$\text{EK } 36 = (1-.36)\times X$$
$$\text{EK } 50 \text{ (if } T/Y > .36) = (1-.50)\times(Y-X)$$
$$\text{EK } 0 \text{ (if } T/Y < .36) = Y-X$$

22. Specifically, the calculation converts the DM100 into DM71.4 of income subject to the 36 percent distribution rate ($.36+.5\times(DM100-X) = DM40$) and the remainder, DM28.6, into income subject to the 50 percent statutory rate ($DM100-DM71.4 = DM28.6$). This translates into available net equity of DM45.7 in the EK 36 category ($.64\times DM71.4$) and DM14.3 in the EK 50 category ($.50\times DM28.6$).

23. Specifically, the calculation converts the DM100 into DM69.4 of income subject to the 36 percent distribution rate ($.36X = DM25$) and the remainder, DM30.6, into income subject to the zero rate ($DM100-DM69.4 = DM30.6$)). This translates into available net equity of DM44.4 in the EK 36 category ($.64\times DM69.4$) and DM30.6 in the EK 0 category ($DM100-DM69.4$).

24. The rules for carrybacks and carryforwards of net operating losses are designed to prevent the refund of an amount of tax that, by virtue of the imputation credit, has already been used to offset shareholder taxes. In summary, when a German corporation suffers a net operating loss for a year, it first enters the full amount of the loss as a negative adjustment to its

EK 02 account. The corporation may then carry back the loss for two years and (to the extent the loss is not absorbed in these years) may carry forward the loss indefinitely.

With respect to carrybacks, the loss may be deducted in the earlier year, and generate a refund, only to the extent of taxable income in that year less the sum of (1) any distributions in that year and (2) the distribution tax (36 percent) on such distributions. In effect, a carryback deduction is only allowed against taxable income if the tax on such income has not already been returned to shareholders by way of credit.

If the NOL is not absorbed through carrybacks, it is carried forward and deducted in later years. As the loss is deducted (and is thereby automatically reflected in the EK 50 account), it is credited against the original negative adjustment to the EK 02 account.

25. All German enterprises (including foreign corporations with permanent establishments in Germany) also are subject to the municipal "trade tax." This tax has both income tax and capital tax components. The basic trade tax rates are set by the Federal Government, but the local governments (which collect the tax) have considerable discretion to increase them. The income tax component is typically 15 percent. The trade tax is deductible in computing a corporation's normal tax liability. The trade tax is not taken into account in the examples in this summary.

26. Tax is always withheld on dividends at the statutory 25 percent rate at the time of distribution (except as noted below). Shareholders entitled to reduced withholding under a treaty must apply the German tax authorities for a refund of the excess withholding. This rule applies even to publicly traded shares.

Some treaties contain an anti-avoidance rule designed to discourage corporations from distributing profits to nonresident shareholders who reinvest these profits in the same corporation in order to gain the benefit of the lower distribution rate on what are, in effect, retained profits. Such distributions are subject to a higher withholding tax than normal distributions. (The 1954 U.S.-Germany treaty had such a provision, but it was unilaterally waived by Germany in 1981.)

27. The following example illustrates the treatment of foreign source income and foreign stockholders. Assume a German corporation has two foreign branches, the first in a treaty country (Country 1) and the second in a nontreaty country (Country 2). The corporation has DM100 of German profits, DM100 of Country 1 profits, and DM100 of Country 2 profits (all pre-tax). The German profits are taxed at the statutory rate of 50 percent. The Country 1 profits are taxed in Country 1 at a rate of 25 percent and are exempt in Germany (under the Business Profits and Double Taxation articles of the treaty). The Country 2 profits are taxed in Country 2 at a rate of 30 percent and are subject to tax in Germany, but the German tax is reduced by a foreign tax credit. During the next year (when the corporation has no profits anywhere), all of the prior year profits are distributed to a foreign shareholder (who enjoys no treaty benefits).

The German profits of DM100 produced equity of DM50 in the EK 50 account. When these profits are distributed, the corporation receives a refund of DM14, also distributed to the foreign shareholder. The distribution of DM64 is subject to 25 percent withholding of DM16. The foreign shareholder receives no imputation credit with respect to this distribution.

The Country 1 profits of DM100 produced equity of DM75 in the EK 01 account. When this equity is distributed, it is subject to the 36 percent distribution tax (DM27), but the tax is credited and refunded to the foreign shareholder. The entire distribution (DM75−DM27+DM27) is subject to 25 percent withholding (DM18.75).

The Country 2 profits of DM100 were reduced by DM30 of Country 2 tax, and then by an additional DM20 of German tax (at the statutory rate of 50 percent after the foreign tax credit). In allocating this income to EK accounts, the corporation is considered to have paid tax of DM20 on profits of DM70 (an overall tax rate of 28.6 percent). Specifically, the corporation is treated as having paid a 36 percent tax on DM55.6 and a 0 percent tax on DM14.4. This produced equity of DM35.6 in EK 36 (55.6−(55.6×36%)) and DM14.4 in EK 01. When the profits are distributed, the distribution out of EK 36 is not subject to any further tax and produces a refunded credit of 36/64, or DM20. The distribution out of EK 01 is subject to the 36 percent distribution tax, which is refunded. This results in a distribution, including refunds, of DM70 (DM35.6+DM20+DM14.4−DM5.2+DM5.2 = DM70). The total distribution is subject to statutory withholding of 25 percent (DM17.5).

The treatment of pre-1977 profits is illustrated by the following. Assume the corporation in the above example had only DM100 of German profits, which were earned in 1976 and were subject to a tax of 56 percent at that time. The net profits of DM44 were placed in EK 03 in 1977, when the integration system was implemented. When these profits are distributed to a foreign shareholder in 1990, they are subject to a distribution tax of 36 percent (DM15.8), which is credited and refunded to the shareholder, producing a total distribution of DM44. This total distribution is subject to statutory withholding of 25 percent (DM11).

28. The following example illustrates the mechanics of New Zealand's credit system. A corporation earns income of NZ$100, of which NZ$60 is taxable, and the tax is NZ$19.80 (at a 33 percent rate). The corporation distributes the remaining NZ$81.20 to its shareholders. The payment of tax of NZ$19.80 gives rise to a credit to the ICA in the same amount. The maximum amount of credits that can be allocated to the distribution is NZ$33.99 (NZ$60×.33/(1−.33)). However, the corporation only allocates a credit of NZ$19.80 to the distribution to avoid having a negative ICA and incurring penalties. Not taking into account the refundable resident withholding tax, the shareholder would include NZ$100 in income (the cash distribution plus the attached credits), and have tax liability of NZ$33 and a credit of NZ$19.80. As a result, the shareholder has additional tax liability of NZ$13.20.

29. Until March 31, 1991, the CFC regime applied only to a transitional list of low-tax countries (the "black list" countries). As of April 1, 1991, the new regime applies in full to a CFC resident in any country other than Australia, the United States, the United Kingdom, Japan, France, Germany or Canada (the "grey list" countries). The CFC rules apply to investors in a CFC resident in a grey list country only if the CFC has taken advantage of overseas "specified tax preferences," and only if New Zealand tax exceeds the foreign tax that would be payable if the item were not a preference under that foreign country's tax laws. To date, there is only one scheduled specified tax preference, namely, any exemption from income tax for income derived from a business carried on outside the country.

30. The shareholder continuity rules do not apply to any corporation whose shares are listed on the New Zealand Stock Exchange.

31. The amount of the imputation credit is $[(D/(1-.25)]\times.25 = D/3$ where D equals the amount of net qualifying distributions.

32. The following example illustrates the mechanics of the imputation credit and ACT. The example assumes: (1) a corporate tax rate of 33 percent, (2) a basic personal rate of 25 percent, (3) that all shareholders are taxed at a marginal rate of 25 percent, and (4) that the corporation distributes to shareholders all after-tax (including ACT) earnings.

A.	Corporate income before preferences	£100.00
B.	Preference deductions or exclusions (e.g., accelerated cost recovery in excess of book depreciation)	40.00
C.	Corporate taxable income (A−B)	60.00
D.	Corporate tax (.33×C)	19.50
E.	Cash distributions to shareholders ((A−F−I) or (A−[(.33−.25)/1.33)	71.40
F.	ACT (E×.25/(1−.25))	23.80
G.	Limit on use of ACT (.25×C)	15.00
H.	ACT applied against mainstream corporate tax (lesser of F and G)	15.00
I.	Net mainstream tax (D−H)	4.80
J.	Total tax paid by corporation (F+I)	28.60
K.	Retained earnings (A−E−J)	0.00
L.	Surplus ACT credit available for carryback or carryforward (F−H)	8.80
M.	Shareholder income (E+F)	95.20
N.	Shareholder tax (.25×M)	23.80
O.	Shareholder tax net of imputation credit (N−F)	0.00
P.	Total corporate and shareholder tax paid (J+O)	28.60

If the shareholder in the example were instead a tax-exempt entity, the shareholder would be eligible for a refund of the entire imputation credit of £23.80. Accordingly, the total tax paid by the corporation and the shareholder would be £4.80, the net mainstream tax paid by the corporation.

33. An indirect foreign tax credit is allowed with respect to taxes paid by a foreign corporation to a U.K. corporation that owns at least 10 percent of the foreign corporation. A similar credit is allowed if the foreign corporation is a controlled foreign corporation the income of which is taxed currently to a U.K. shareholder.

34. Assume that a corporation earns £100 (of which £70 is U.K. source and £30 is foreign source income) and pays foreign tax of £9 on the foreign source income (at a 30 percent rate). The corporation's mainstream tax is £24, of which £23.10 is attributable to U.K. income (.33×£70) and £0.90 is attributable to to foreign source income ((.33×£30)−£9). The corporation distributes £60 and pays ACT of £20. Under the general limit described in Section B.6.b, the corporation may apply the ACT of £20 against its mainstream tax on U.K.-source income only to the extent of 25 percent of £70, or £17.50. The corporation also may apply ACT against the £0.90 of U.K. mainstream tax payable on the foreign source income (the

lesser of the mainstream tax payable and 25 percent of £30 of foreign source income). Thus, the corporation offsets £18.40 (£17.50+£0.90) of ACT against its mainstream tax liability of £24 and therefore must make an additional payment of £5.60. The corporation's total U.K. tax liability is £25.60.

35. The following example illustrates the difference in treatment of shareholders in countries with such treaties and shareholders in countries without such treaties.

Example. A corporation distributes a total of £300, consisting of £75 to each of the following: Shareholder A, a national of a nontreaty country, Shareholder B, a U.S. national owning less than 10 percent of the stock, Shareholder C, a U.K. resident, and Shareholder D, a U.S. national owning at least 10 percent of the stock. Shareholders A and C are subject to tax in the United Kingdom at a marginal rate of 40 percent, Shareholder B is subject only to the 15 percent withholding tax, and Shareholder D is subject only to the 5 percent withholding tax. The corporation pays ACT of £100 (£300×.25/(1−.25), or £25 on each distribution.

Shareholder A is treated as receiving a distribution of only the £75 actually paid to him and is liable for tax of £30 (.40×£75). Shareholder A is treated as having paid tax of £18.75 (.25×£75) due to the ACT paid by the corporation. Thus, Shareholder A must pay an additional £12.25.

Shareholder B is treated as receiving a distribution of £100 and is liable for tax of £15 (.15×£100). Shareholder B is treated as having paid £25 (ACT paid on the distribution), and thus is entitled to a refund of £10.

Shareholder C also is treated as receiving a distribution of £100 and is liable for tax of £40. Shareholder C is treated as having paid £25, and thus must pay an additional £15.

Shareholder D is treated as receiving a distribution of £87.50 (£75 actually distributed plus one-half of the ACT) and is liable for tax of £4.38 (.05×£87.50). Shareholder D is treated as having paid £12.50 (one-half of the ACT), and thus is entitled to a refund of £8.13.

Appendix C

1. In that case, the credit would not only be nonrefundable but also would not be allowed to offset tax on other income of shareholders subject to tax at less than the maximum rate. The imputation credit prototype, described in Chapter 11, is a hybrid of these two approaches. It allows credits at the maximum shareholder rate but permits low-bracket shareholders to use excess credits against other tax liability.

2. The second to last column of the example that follows in the text illustrates that this approach will pass through preferences if the corporate and shareholder rates are identical.

3. Corporate tax credits could be passed through by treating credits as equivalent to corporate taxes paid. Corporate preferences that are exclusions from income could be passed through to shareholders by a separate accounting at the corporate level and exclusion at the shareholder level. Passing through deferral preferences, however, would be more difficult because some account would have to be taken of their reversal over time. The corporate AMT, for example, has a credit for AMT taxes against future regular income taxes. Alternatively, asset basis might be adjusted. Either of these approaches would be complicated at the shareholder level. See McLure (1979), pp. 95-99.

4. There may be an indirect benefit to tax-exempt shareholders if a dividend exclusion system results in increased stock prices.